87-36 (2)

No. 87-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

INVESTMENT COMPANY INSTITUTE and
SECURITIES INDUSTRY ASSOCIATION,

Petitioners,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, *et al.*,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

APPENDIX

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UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 84-1616

INVESTMENT COMPANY INSTITUTE and
SECURITIES INDUSTRY ASSOCIATION,

Petitioners,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, *et al.*,

Respondents.

Petition For Review Of An Order Of The
Federal Deposit Insurance Corporation

No. 85-5769

INVESTMENT COMPANY INSTITUTE, *et al.*,

Appellants

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, *et al.*

Appeal from the United States District Court for the
District of Columbia

(D.C. Civil Action No. 84-3875)

Argued April 18, 1986
Decided April 7, 1987

Bills of costs must be filed within 14 days after entry of judgment. The court looks with disfavor upon motions to file bills of costs out of time.

Harvey L. Pitt, with whom *Henry A. Hubschman* and *David M. Miles* were on the brief, for petitioners in No. 84-1616 and appellants in No. 85-5769.

Theodore C. Hirt, Attorney, Department of Justice, with whom *Richard K. Willard*, Assistant Attorney General, *Joseph E. diGenova*, United States Attorney, *John C. Murphy, Jr.*, General Counsel, Federal Deposit Insurance Corporation, *Ronald Glancz*, Assistant General Counsel, Federal Deposit Insurance Corporation, and *Anthony J. Steinmeyer*, Attorney, Department of Justice, were on the brief, for respondents in No. 84-1616 and appellees in No. 85-5769.

Michael S. Helfer was on the brief for *amicus curiae* Dealer Bank Association, urging affirmance.

John T. Gill, III, *Johanna M. Sabol*, and *Michael F. Crotty* were on the brief for *amicus curiae* American Bankers Association, urging affirmance.

Before STARR and SILBERMAN, *Circuit Judges*, and WRIGHT, *Senior Circuit Judge.*

Opinion for the court *per curiam*.

PER CURIAM: Petitioners/appellants Investment Company Institute (ICI) and Securities Industry Association (SIA) challenge regulations of the Federal Deposit Insurance Corporation (FDIC) governing the activities of insured banks that are not members of the Federal Reserve System. Petitioners principally argue that insofar as FDIC regulations allow nonmember insured banks to have subsidiary or affiliate relationships with firms engaged in securities work, those regulations violate the command of § 21 of the Banking Act of 1933 (Glass-Steagall Act), 12 U.S.C. § 378 (1982), that securities firms shall not engage in receiving deposits "to any extent whatever." We cannot agree. The clear language of the Glass-Steagall Act demonstrates that Congress intended to differentiate between the activities of banks and the activities of banks' subsidiaries and affiliates. As we see no provision in the Act, including § 21, that prohibits subsidiaries

or affiliates of nonmember insured banks from engaging in securities work, and because we find unmeritorious petitioners' arguments under §§ 2[6] and 2[8] of the Federal Deposit Insurance Act, 12 U.S.C. §§ 1816, 1818 (1982), we affirm the District Court's grant of summary judgment for the defendants, *see ICI* v. *FDIC*, 606 F. Supp. 683 (D. D.C. 1985), and dismiss the petition for review of the regulation.

I. BACKGROUND

Federal regulation effectively divides the United States commercial banking community into three major categories.[1] Banks that choose to become members of the Federal Reserve System fall under the jurisdiction of the Board of Governors of the Federal Reserve System. *See* 12 U.S.C. §§ 221, 248 (1982). National banks come within the jurisdiction of the Comptroller of the Currency. *See id.* Finally, insured state banks that are not members of the Federal Reserve System operate under the watchful eye of the FDIC. *See id.* §§ 1811, 1815. Although the FDIC insures the deposit of all three categories, *id.* § 1811, it regulates directly only the third group. *See generally id.* § 1815. The Glass-Steagall Act seeks to draw a sharp line between the activities of these three categories of commercial banks and the activities of investment banks and other securities firms. *Id.* §§ 24, 78, 377, 378; *Board of Governors* v. *Investment Company Institute*, 450 U.S. 46, 63 (1981) ("*Board of Governors*").

This case explores the periphery of the separation of the banking and securities industries mandated by the Glass-Steagall Act. As the condition and character of the two industries have shifted over the past fifty years, the separation policy has shifted as well. Its changing shape has promoted particularly significant and protracted litigation in recent years, *see, e.g.*, *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 137 (1984) ("*Becker*") (commercial paper is a security under the Glass-Steagall Act);

1. A "fourth" category, consisting of the 27 Federal Savings Banks regulated by the Federal Home Loan Bank Board, is a much smaller element of the banking community. *See* Brief for Appellees/Respondents at 4; 12 U.S.C. § 1464(a) (1982).

Securities Industry Ass'n v. *Board of Governors*, 468 U.S. 207 (1984) ("*Schwab*") (Board may allow bank holding company to acquire affiliate engaged in securities brokerage); *Securities Industry Ass'n* v. *Board of Governors*, 807 F.2d 1052, 1058 (D.C. Cir. 1986) (Board may allow banks to sell third-party commercial paper), and has prompted this court to call upon Congress to clarify its precise contours. *American Bankers Ass'n* v. *SEC*, 804 F.2d 739, 755-56 (D.C. Cir. 1986) (SEC has no authority to regulate securities activities of banks).

The specific issue presented here is the extent to which Congress intended to bar subsidiaries and affiliates of insured nonmember banks from engaging in the securities business. In September 1982 the FDIC published in the Federal Register a policy statement that found the Glass-Steagall Act "does not prohibit an insured nonmember bank from establishing an affiliate relationship with or organizing or acquiring a subsidiary corporation that engages in the business of issuing, underwriting, selling, or distributing stocks, bonds, debentures, notes, or other securities." 49 Fed. Reg. 46709 (Nov. 28, 1984). *See* 47 Fed. Reg. 38984 (Sept. 3, 1982). The FDIC did note, however, that the securities activities of such affiliates or subsidiaries might raise questions of "unsafe or unsound banking practices" and practices not "consistent with the purposes of" deposit insurance under §§ 2[6] and 2[8] of the Federal Insurance Act (FDIA), 12 U.S.C. §§ 1816, 1818 (1982). *Id.*[2]

In November 1984, after notice and comment proceedings, the FDIC adopted a final rule regulating the securities activities of affiliates and subsidiaries of insured nonmember banks under §§ 2[6] and 2[8] of the FDIA. 49 Fed. Reg. 46709 (Nov. 28, 1984), regulations *codified at* 12 C.F.R. § 337.4 (1986). Although the rule does not prohibit such securities activities outright, it does restrict that activity in a number of ways. Banks

2. Petitioners challenged the Policy Statement. Their suit was dismissed without prejudice, pending the outcome of FDIC's rulemaking process. *Investment Company Institute* v. *United States*, D.D.C. Civil Action No. 82-2532, filed September 8, 1982.

may only maintain "bona fide" subsidiaries that engage in securities work. The rule defines "bona fide subsidiary" so as to limit the extent to which banks and their securities affiliates and subsidiaries may share company names or logos, as well as places of business. 12 C.F.R. § 337.4(a)(2)(ii), (iii); 49 Fed. Reg. at 46710. The definition also requires banks and subsidiaries to maintain separate accounting records and to observe separate corporate formalities. 12 C.F.R. § 337.4(a)(2)(iv), (v). The two entities cannot share officers, and must conduct business pursuant to independent policies and procedures, including the maintenance of separate employees and payrolls. *Id.* § 337.4(a)(2)(vi), (vii), (viii); 49 Fed. Reg. at 46711-12. Finally, and perhaps most importantly, the rule requires a subsidiary to be "adequately capitalized." 12 C.F.R. § 337.4(a)(2)(i).

Petitioners Investment Company Institute and Securities Industry Association, representing mutual fund companies and investment bankers, simultaneously filed a petition for review in this court and an action to enjoin the regulation in the United States District Court for the District of Columbia. They argue that the rule violates § 21 of the Glass-Steagall Act, 12 U.S.C. § 378 (1982), and §§ 2[6] and 2[8] of the Federal Deposit Insurance Act. 12 U.S.C. § § 1816, 1818 (1982). We stayed our proceedings until the District Court had ruled on the matter. Order of February 19, 1985. District Judge Gesell, on cross-motions for summary judgment, upheld the FDIC's regulations and dismissed the ICI and SIA action. *ICI* v. *FDIC*, 606 F. Supp. 683 (D. D.C. 1985). We consider now both the appeal from that judgment (No. 85-5769), and the original petition for review of the FDIC rule (No. 84-1616).

II. PETITIONERS' STANDING UNDER THE GLASS-STEAGALL ACT AND THE FEDERAL DEPOSIT INSURANCE ACT

Before we address the merits of petitioners' challenge, we must examine the standing of securities industry plaintiffs to challenge the FDIC rule at issue. At the outset, we note that petitioners

have shown sufficient "injury in fact" from these regulations for standing purposes. The FDIC will deal petitioners competitive injury by allowing insured nonmember banks to enter the securities field indirectly through subsidiaries and affiliates. *See, e.g., Hardin* v. *Kentucky Utilities Co.*, 390 U.S. 1, 6 (1967); *Chicago Junction Case*, 264 U.S. 258 (1924); *see also ICI* v. *FDIC*, 606 F. Supp. at 684 (FDIC regulation "plainly threatens" economic injury to securities firms).

But the standing inquiry, of course, does not end with "injury in fact." Competitive injury alone does not confer standing. *Hardin*, 390 U.S. at 5-6. Once we find such injury, we must turn to the "prudential" or "zone of interests" standing test enunciated by the Supreme Court in *Association of Data Processing Services* v. *Camp*, 397 U.S. 150, 153 (1970). If the interest the petitioner seeks to protect is "arguably within the zone of interests to be protected or regulated by the statute or constitutional guarantee in question," petitioner has standing.

The Supreme Court recently clarified the meaning of the "zone of interests" standing test in its opinion in *Clarke* v. *Securities Industry Ass'n*, 107 S. Ct. 750 (1987). In that case securities industry plaintiffs challenged a decision of the Comptroller of the Currency that national bank discount brokering services are not "branch services" for purposes of the McFadden Act. 107 S. Ct. at 754. The McFadden Act places stringent limits on interstate branch banking activities, *see* 12 U.S.C. §§ 36(c) & (f), 81 (1982), and plaintiffs feared that the Comptroller's relatively narrow interpretation of the range of services the Act covers would expose the securities industry to competitive injury. *Clarke*, 107 S. Ct. at 754.

The Court rejected the Comptroller's argument that SIA lacked standing because Congress had not intended the McFadden Act to protect the competitive position of the securities industry. *Id.* at 759. The zone of interests test, stated the Court, "denies a right of review if the plaintiff's interests are so marginally related to or inconsistent with the purposes implicit in the statute that it cannot reasonably be assumed that Congress

intended to permit the suit." *Id.* at 757. The Court found that the security industry's competitive interest bore a "plausible relationship" to the interests Congress sought to protect, *id.* at 759,[3] and that in any event there were "no indications * * * that make 'fairly discernible' a congressional intent to preclude review * * *." *Id., quoting Block* v. *Community Nutrition Institute*, 467 U.S. 340, 347 (1984). Notably, the Court overturned this court's decision in *Control Data Corp.* v. *Baldrige*, 655 F.2d 283 (D.C. Cir.), *cert. denied*, 454 U.S. 881 (1981), and instructed the lower courts to consider "all indicators helpful in discerning" the interests and parties Congress intended to protect. *Clarke*, 107 S. Ct. at 757-58 & n.15.[4]

With these guiding standards firmly in mind, we turn to petitioners' standing in this suit under § 21 of the Glass-Steagall Act and §§ 2[6] and 2[8] of the Federal Deposit Insurance Act.

A. The Glass-Steagall Act

In *Investment Company Institute v. Camp*, 401 U.S. 617, 620-21 (1971), the Supreme Court held that securities industry groups had standing to challenge regulations promulgated under the Glass-Steagall Act that allowed national banks to enter the securities field. The Court concluded that in §§ 16 and 21 of the Act Congress "arguably" had legislated against the competition ICI sought to prevent. 401 U.S. at 620. We find that *Camp* controls our Glass-Steagall standing analysis in the present case.

The FDIC attempts to distinguish *Camp* by pointing out that ICI's challenge here rests on § 21 alone. Section 21 is a criminal

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3. The Court found that Congress intended the Act both to prevent branch banking activities from allowing the concentration of control over money and credit in a small number of powerful national banks, and to equalize the status of state and federal banks. *Clarke*, 107 S. Ct. at 759.

4. The *Control Data* opinion had established a requirement that Congress' intent to protect an interest asserted by a plaintiff be shown via some "slight beneficial indicia" either in the language of the relevant statutory provisions themselves, or in the legislative history of those provisions. 655 F.2d at 293-94. The opinion implicitly forbade consideration of other sources to discern the intent of Congress.

provision, notes FDIC, and thus seeks to protect the *public interest*, not the interests of securities firms. Implicitly, FDIC argues that the *Camp* Court actually rested its standing determination on § 16, not § 21.

Although the FDIC's point on the criminal focus of § 21 is well taken, it does not adequately demonstrate that the present case is different from the situation in *Camp*. First of all, nothing in the *Camp* decision indicates that the Supreme Court meant to distinguish between § 16 and § 21 for standing purposes. 401 U.S. at 620. In fact, the Court's short standing discussion speaks of the two provisions in the same breath, and fails to draw any distinction whatever between them. *Id.* ~~Second,~~ even though § 21 does contain a criminal penalty element, FDIC's authority to interpret that section stems from purely civil enforcement powers. 12 U.S.C. § 1818 (1982). Section 21 has repeatedly and consistently received "civil" regulatory interpretation. *See, e.g.*, *Becker*, 468 U.S. at 139; *Board of Governors*, 450 U.S. at 62. After all, the *Camp* case itself was purely civil in nature. 401 U.S. at 617-18, 639. In fact, petitioners assert, without contradiction by respondents, that no criminal action has *ever* been brought under the section. Supplemental Brief for Appellants/Petitioners at 11 n.* *.

Moreover, it is well established that courts applying the prudential standing test may look for the requisite protective intent on the part of Congress not only in the specific statutory provision at issue but also in other provisions of a statute. *See Clarke*, 107 S. Ct. at 758; *Tax Analysts & Advocates* v. *Blumenthal*, 566 F.2d 130, 141 (D.C. Cir. 1977), *cert. denied*, 434 U.S. 1086 (1978); *see also Autolog Corp.* v. *Regan*, 731 F.2d 25, 30 n.3 (D.C. Cir. 1984). As the Supreme Court has specifically indicated that § 16 and § 21 seek to "draw the same line," *Becker*, 468 U.S. at 149, we appropriately look to § 16 to help inform our standing decisions under § 21. *Clarke*, 107 S. Ct. at 757-58. In so doing, our analysis falls squarely within the Supreme Court's *Camp* holding that ICI has standing under § 16 and § 21 to challenge regulations allowing banks to enter the securities field. As a

consequence, *Camp* controls. Petitioners' standing under § 21 of the Glass-Steagall Act to challenge these regulations is clear.

B. The Federal Deposit Insurance Act

Sections 2[6] and 2[8] of the FDIA speak in broad terms, forbidding bank practices that are not "consistent with the purposes" of federal deposit insurance or that are "unsafe and unsound." 12 U.S.C. §§ 1816, 1818 (1982). Petitioners argue that it is clear from the breadth of this language that Congress has legislated against the very activities that petitioners allege have caused them injury. *See Clarke*, 107 S. Ct. at 756, 759 (*quoting Investment Company Institute* v. *Camp*, 401 U.S. at 620).

Congress enacted the FDIA as part of the Banking Act of 1933, 48 STAT. 162, for purposes of providing for "the safer use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations, and for other purposes * * *." H.R. Rep. No. 150, 73d Cong., 1st Sess. 1 (May 19, 1933). Although Congress did not expressly indicate a desire to protect the competitive position of the securities industry, we cannot say that the industry's interests in limiting bank activities in the securities field are "so marginally related to or inconsistent with the purposes implicit in the statute that it cannot reasonably be assumed that Congress intended to permit the suit." *Clarke*, 107 S. Ct. at 757. As a consequence, we find that petitioners have standing under the FDIA to challenge the regulations at issue here.

The facts of the *Clarke* case bolster this conclusion. In *Clarke* a securities industry plaintiff asserted standing on the basis of competitive injury under the McFadden Act. 107 S. Ct. at 754. The language of that Act does not expressly protect the competitive position of the securities industry, and neither is any such intent on the part of Congress discernible from the legislative history. *See Securities Industry Ass'n* v. *Comptroller of the Currency*, 765 F.2d 1196, 1197 (D.C. Cir. 1985) (*en banc*) (*per curiam*) (Scalia, J., dissenting from denial of rehearing *en banc*)

(dissent from Court of Appeals decision upheld in *Clarke* argues that Congress no more meant the McFadden Act to protect the securities industry's competitive position than it meant the Act to protect the position of "businesses competing for the parking spaces that an unlawful branch may occupy"). Nevertheless, the Supreme Court found that securities industry competitors were "very reasonable candidates" to seek review of the agency's ruling in that case. We see no basis for distinguishing the situation in *Clarke* for standing purposes from that confronting us in the present case.[5]

Finally, we find no indication "fairly discernible in the statutory scheme" of congressional intent to preclude judicial challenges by this particular class of petitioners. *Clarke*, 107 S. Ct. at 757. This case does not, for example, present a situation in which permitting suits by plaintiffs otherwise within the zone of interest would "severely disrupt [a] complex and delicate administrative scheme." *Id.* (*quoting Community Nutrition Institute*, 467 U.S. at 348).

III. THE GLASS-STEAGALL ACT CHALLENGE

Petitioners present a straightforward statutory argument. Section 21 of the Glass-Steagall Act makes it illegal:

> For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits * * *.

---

5. As we find petitioners are within the zone of interests "protected" by the statute, we need not consider the "regulated" prong of the zone test. *See* Reply Brief for Appellants/Petitioners at 4 n.7; *Data Processing*, 397 U.S. at 153. *But see Calumet Industries, Inc.* v. *Brock*, 807 F.2d 225 (D.C. Cir. 1986) ("regulated" prong does not create standing where, at base, the harm alleged stems from an agency's failure to regulate *another* party with sufficient stringency).

12 U.S.C. § 378(a)(1). Petitioners interpret the phrase "to any extent whatever" to bar insured nonmember banks from having subsidiaries or affiliates engaged in the securities business. FDIC responds that when Congress intended to bar subsidiary or affiliate relationships of this sort it clearly indicated that intent, and that in any event the court should defer to its reasonable interpretation.

A.

In weighing these competing interpretations of § 21 and the Glass-Steagall Act, we are bound by a venerable line of precedent counseling judicial deference toward an agency's evaluations of the statutes that give it legal life and authority. *See, e.g., NLRB* v. *Hearst Publications, Inc.*, 322 U.S. 111, 131 (1944); *Red Lion Broadcasting Co.* v. *FCC*, 395 U.S. 367, 381 (1969). That line of cases recently culminated in the Supreme Court's decision in *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984) which established a simple two-part test, now familiar. If Congress has spoken clearly to the issue presented in a case, that intent controls. 467 U.S. at 844. If the agency's interpretation is contrary to the clear intent of Congress, the agency's interpretation is invalid. If, on the other hand, Congress had no clear intent as to the particular question at issue, the courts may invalidate the agency's interpretation only if it is "unreasonable" or "impermissible." *Id.* As we find in the present case that Congress clearly intended § 21 to allow insured nonmember banks to maintain subsidiary or affiliate relationships with securities firms, we uphold FDIC's interpretation of § 21 and affirm the District Court. Given this clear intent, we need not reach *Chevron's* "reasonableness" prong of analysis.

B.

Congress enacted the Glass-Steagall Act in response to the dramatic wave of bank failures of the early Depression, a wave that many perceived to have been the result of securities speculation by the banking industry. *See Board of Governors*, 450 U.S.

at 61 & n.28; *Camp*, 401 U.S. at 629-30. The Act seeks to separate the banking and securities industries "as completely as possible." *Board of Governors*, 450 U.S. at 70. But while Congress may have intended to build an insurmountable barrier between member banks of the Federal Reserve System and the securities industry, *see* 12 U.S.C. §§ 24, 78, 377 (1982), Congress was far from certain in 1933 that it had authority to effect such a sweeping separation for insured state nonmember banks. In fact, several members of Congress nervously commented during the debate leading to enactment of the bill that Congress might lack power to regulate nonmember banks at all. *See* 75 Cong. Rec. 9905 (May 10, 1932) (remarks of Sen. Walcott); *id.* at 9911, 9913-14 (remarks of Sen. Bulkley).

The hesitation of the 73rd Congress to regulate state nonmember banks is quite apparent in the actual language of the Act. National banks and banks that have chosen to become members of the Federal Reserve System are subject to stringent regulation that bars them from the securities field. Section 16 severely limits the ability of *national* banks to deal in securities and bars them from underwriting securities. 12 U.S.C. § 24(1982); *see also Securities Industry Ass'n* v. *Board of Governors*, 807 F.2d 1052 (D.C. Cir. 1986). Section 20 bars firms "principally" engaged in securities transactions from affiliating with *member* banks 12 U.S.C. § 377 (1982). Section 32 bars *member* banks from sharing officers or board members with securities firms. 12 U.S.C. § 78 (1982).

Only § 21 regulates both *member* and *nonmember* banks. Section 21 bars *any* "person, firm, corporation, association, business trust, or other similar organization" from engaging in securities business while receiving deposits "to any extent whatever." 12 U.S.C. § 378 (1982). It says nothing explicitly about the propriety of insured nonmember banks establishing subsidiaries or affiliates that engage in the securities business. Petitioners suggest, nevertheless, that Congress intended that the section prohibit such relationships.

This argument is difficult to support. If we read § 21 to prohibit insured nonmember banks from establishing securities subsidiaries or affiliates, the coherence of the the statute as a whole begins to crumble. Section 21 applies to both member and nonmember banks. If it prohibits all bank affiliate or subsidiary relationships with securities firms, then § 20's somewhat permissive language, which allows *member* banks to establish affiliate relationships with firms doing some limited amount of securities work, becomes meaningless. Accepting petitioners' interpretation, therefore, would require us to eliminate a provision of the statute, a clear violation of a fundamental canon of construction. *See National Insulation Transportation Committee* v. *ICC*, 683 F.2d 533, 537 (D.C. Cir. 1982); *In re Surface Mining Regulation Litigation*, 627 F.2d 1346, 1362 (D.C. Cir. 1980).

Petitioners play down this difficulty by arguing that § 20 constitutes a special exception for member banks to the general prohibition set out by § 21. Petitioners submit that although banks generally cannot maintain affiliate or subsidiary relationships with securities firms "to any extent whatever," § 20 specifically authorizes *member* banks to maintain such relationships with firms not "principally" engaged in securities work. *Nonmember* banks, however, cannot maintain such relationships. This explanation suffers from two readily apparent flaws.

First of all, Congress knew how to indicate that a section of the Act was intended as a specific exception to another section. Congress amended § 21 in 1935 to include language that expressly indicated that activities implicitly authorized under § 16 of the Act were not barred by § 21's broad language. Act of August 23, 1935, c. 614, § 303, 49 STAT. 707; *see also Securities Industry Ass'n* v. *Board of Governors*, 807 F.2d 1052, 1056 (D.C. Cir. 1986) (discussing interplay of §§ 16 and 21). Congress has not done the same for § 20, and we see no basis whatever for inferring such intent. On the contrary, § 20 speaks in the language of prohibition, not authorization. Member banks "shall not be affiliated in any manner * * * with any corporation, association, business trust, or other similar organization engaged principally" in

securities activities. 12 U.S.C. § 377 (1982). Congress presumably did not indicate that § 20 should be an "exception" to § 21 because it did not intend that § 21 should extend to the activities of affiliates and subsidiaries in the first place. The two sections regulate separate activities.

Second, if we were to accept petitioners' argument that § 20 exempts member banks from the full prohibitory force of a § 21 that applies to both banks and their affiliates, we would be left with an anomalous result. Under petitioners' interpretation, *member* banks would be subject to *less* stringent § 21 regulation than would be insured *nonmember* banks. This outcome is dramatically counter to what we would expect on examination of the statute and its history. It seems clear that Congress felt its efforts to regulate nonmember banks rested on shaky, if not ramshackle, authority. Members of Congress explicitly discussed this problem as it pertained to regulation of nonmember bank affiliates, and specifically indicated that regulation of such affiliates was probably beyond the power of Congress.[6]

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6. In fact, one passage seems nearly sufficient in itself to establish that Congress did not mean § 21 to extend to nonmember bank affiliates and subsidiaries:

> Mr. FESS. Earlier in the Senator's presentation he mentioned the fact that whether it be a national bank or a State bank, the control of affiliates does not extend outside of the Federal reserve set-up; that is, an affiliate of a State bank that is not a member of the Federal reserve system is not covered, is it?
>
> Mr. WALCOTT. Mr. President, there are state banks which exist now within the Federal reserve system, and they are member banks.
>
> Mr. FESS. Yes.
>
> Mr. WALCOTT. There are national banks within the Federal reserve system. Most of the national banks are under the Federal reserve system; so that, whether State or whether national, provided the bank is a member of the Federal reserve system and has an affiliate, that affiliate must be divorced within three years.
>
> Mr. FESS. The provision does not attempt to go beyond the Federal reserve system?
>
> Mr. WALCOTT. It does not control State banking, and the reason for that is obvious: The Federal Government has no jurisdiction over State banks.

(footnote continued on next page)

That Congress would have imposed more demanding regulation on nonmember banks than on member banks, given this uncertainty, seems utterly improbable. Absent clear evidence, we will not infer that Congress had such contrary, even irrational, intentions for the statute.

Despite petitioners' considerable efforts, then, the language and structure of the Glass-Steagall Act do not support the view that § 21 bars insured nonmember banks from maintaining affiliate or subsidiary relationships with securities firms. Section 21 on its face fails to prohibit such relationships, and any judicial inference of such a prohibition would be inconsistent with the overall structure of the Act. This reasoning standing on its own demonstrates not only that FDIC's interpretation of § 21 is "permissible" but, in fact, that it is the only valid approach.

Moreover, the Supreme Court's guidance on the proper scope of § 21 supports the agency's interpretation. In *Board of Governors* v. *Investment Company Institute*, 450 U.S. 46 (1981), the Supreme Court addressed the argument that § 21 applies to bank holding companies as well as to banks, and that as a consequence it bars bank holding company subsidiaries from engaging in securities work. The Court found that "the language of § 21 cannot be read to include within its prohibition separate organizations related by ownership with a bank, which does receive deposits." 450 U.S. at 58 n.24. As if this statement were not clear enough, the Court went on to emphasize that because § 20 specifically addressed the proper relationship between member banks and securities affiliates, "the structure of the Act reveals a congressional intent to treat banks separately from their affiliates. The reading of the Act urged by respondent [arguing for 'single entity' treatment of banks and their affiliates under § 21] would render § 20 meaningless." *Id.* And to lay the question to rest once and for all, the Court stated that under Glass-Steagall "bank affiliates may be authorized to engage in certain activities that are

(footnote continued from previous page)

75 Cong. Rec. 9905 (May 10, 1932), *quoted in* 606 F. Supp. at 686 n.6. District Judge Gesell described this discussion as "unequivocal," and we are hard-pressed to disagree.

prohibited to banks themselves." *Id.* at 60. In light of our reasoning above, this language clearly guides the proper holding on the issue presented in this case. The agency's interpretation of § 21 entirely consistent with Congress' intent, and must stand.

C.

Petitioners put forward no direct response to the Supreme Court's analysis in *Board of Governors*. Instead, they argue that the FDIC's rule is at odds with "the legislative purpose underlying Section 21." Brief for Appellants/Petitioners at 21. This is not a legislative history argument aimed at proving that the express terms of § 21 actually do bar nonmember bank activities of the sort the petitioners challenge. Rather, petitioners' argument merely adverts to the general policy objectives of the Glass-Steagall Act and attempts to demonstrate that those policies are thwarted, or at least are not furthered, by the FDIC rule at issue here. *Id.* at 27-33.

Petitioners' policy arguments can carry but little weight in a judicial forum. Our duty as a court is to interpret the banking laws, not to set national banking policy on the basis of general objectives set out by Congress. *See, e.g., American Bankers Ass'n*, 804 F.2d at 749. Petitioners have failed to demonstrate that Congress' intent in this provision is unclear. Even if they had, and if every policy objection they raise were irrefutable, we could not overturn FDIC's regulation unless the face of the statute and its legislative history demonstrated that FDIC's interpretation was "impermissible" or "unreasonable." *Chevron*, 467 U.S. at 843-44. Petitioners' "legislative purpose" arguments do not take this approach, however. They focus on policy alone. As the Supreme Court recently stated, "When a challenge to an agency construction, fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left by Congress, the challenge must fail." *Chevron*, 467 U.S. at 866. It is not our place to implement congressional policy in ways Congress itself fails to pursue. *Board of Governors* v. *Dimension Financial Corp.*, 106 S. Ct.

681, 688-89 (1986); *TVA* v. *Hill*, 437 U.S. 153, 194-95 (1978). Congressional intent for § 21 is clear, and FDIC's interpretation is in line with that intent. We need go no further to uphold FDIC's view of the matter.

IV. THE FEDERAL DEPOSIT INSURANCE ACT CHALLENGES

Petitioners also argue that the rule violates the "unsafe and unsound banking practices" provisions of the Federal Deposit Insurance Act. 12 U.S.C. §§ 1818(a) & (b), 1816 (1982) (powers of state chartered banks must be "consistent with the purposes of" federal deposit insurance). Quoting the Fifth Circuit, petitioners assert that the FDIC rule here presents an "abnormal risk of loss or damage to an institution, its shareholders, or the agencies administering the insurance funds." Brief for Appellants/Petitioners at 33-34, *quoting Gulf Federal Savings & Loan Ass'n* v. *Federal Home Loan Bank Board*, 651 F.2d 259, 264 (5th Cir. 1981).

The FDIC itself, of course, has recognized that bank subsidiaries and affiliates engaged in securities activities pose dangers under these two sections. *See* 49 Fed. Reg. at 46709. In fact, the rule promulgated by the FDIC undertakes to ensure that the harms Congress sought to prevent with the Federal Deposit Insurance Act do not become real. Petitioners' argument, then, is not that the rule is inconsistent with these sections of the FDIA, but rather that the rule does not go far enough, as it fails to find affiliate or subsidiary relationships of this kind *per se* "unsafe and unsound."

The failure of this challenge on its merits is unquestionable. Petitioners' FDIA arguments rest, in the first instance, on the assumption that the FDIC rule is invalid under § 21. *See* Brief for Appellants/Petitioners at 34. As we have found above that the rule is entirely consistent with § 21, this element of petitioners' argument collapses of its own weight.

But even if we read the FDIA challenge to include an *independent* attack on the FDIC rule, it does not persuade us to invalidate

that rule. Petitioners have not demonstrated that when Congress used the broad language "unsafe and unsound banking practices" it intended a specific result on the issue presented here. And for good reason. Congress intended to delegate a substantial degree of authority to the agency by the use of this language. *See Investment Company Institute* v. *FDIC*, 728 F.2d 518 (D.C. Cir. 1984); *Independent Bankers Ass'n* v. *Heimann*, 613 F.2d 1164, 1169 (D.C. Cir. 1979). Authority to determine what constitutes an "unsafe" or "unsound" banking practice is firmly committed to the agency. *See, e.g., First National Bank of Lamarque* v. *Smith*, 610 F.2d 1258, 1265 (5th Cir. 1980).

Under the Supreme Court's *Chevron* analysis, if the intent of Congress on a particular issue is not clear, the courts may only overturn the agency's view of that issue if it is "impermissible" or "unreasonable." *Chevron*, 467 U.S. at 843-44. Petitioners have given us no rationale that demonstrates the "unreasonableness" of FDIC's decision to impose stringent regulations on insured non-member banks' affiliate and subsidiary relationships with securities firms, in lieu of pursuing an outright ban on such relationships. As the regulation adopted by the FDIC represents precisely the sort of expert decision Congress committed to that agency, *see Investment Company Institute v. FDIC*, 728 F.2d at 523, petitioners' mere assertion that it is inconsistent with the underlying policies of the FDIA simply cannot carry the day. We find that the agency's rule is consistent with §§ 2[6] and 2[8] of the FDIA.

V. CONCLUSION

Petitioners have standing to challenge these FDIC regulations under the Glass-Steagall Act and the FDIA. As the FDIC has demonstrated, however, that its rule is consistent with the clear intent of Congress in the Glass-Steagall Act, and because we find FDIC's construction of the broad language of FDIA §§ 2[6] and 2[8] to be reasonable, we affirm the District Court's grant of summary judgment in No. 85-5769, and dismiss the petition for review in No. 84-1616.

So ordered.

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**UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT**

No. 84-1616

INVESTMENT COMPANY INSTITUTE and
SECURITIES INDUSTRY ASSOCIATION, *Petitioners*
v.
FEDERAL DEPOSIT INSURANCE CORPORATION, *et al.*,
Respondents

Petition For Review Of An Order Of The
Federal Deposit Insurance Corporation

No. 85-5769

INVESTMENT COMPANY INSTITUTE, *et al.*, *Appellants*
v.
FEDERAL DEPOSIT INSURANCE CORPORATION, *et al.*

Appeal from the United States
District Court for the District of Columbia
(D.C. Civil Action No. 84-3875)

Argued April 18, 1986
Decided January 16, 1987

Bills of costs must be filed within 14 days after entry of judgment. The court looks with disfavor upon motions to file bills of costs out of time.

Harvey L. Pitt, with whom *Henry A. Hubschman* and *David M. Miles* were on the brief, for petitioners in No. 84-1616 and appellants in No. 85-5769.

Theodore C. Hirt, Attorney, Department of Justice, with whom *Richard K. Willard*, Assistant Attorney General, *Joseph E. diGenova*, United States Attorney, *John C. Murphy, Jr.*, General Counsel, Federal Deposit Insurance Corporation, *Ronald Glancz*, Assistant General Counsel, Federal Deposit Insurance Corporation, and *Anthony J. Steinmeyer*, Attorney, Department of Justice, were on the brief, for respondents in No. 84-1616 and appellees in No. 85-5769.

Michael S. Helfer was on the brief for *amicus curiae* Dealer Bank Association, urging affirmance.

John T. Gill, III, Johanna M. Sabol, and *Michael F. Crotty were on the brief for amicus curiae* American Bankers Association, urging affirmance.

Before STARR and SILBERMAN, *Circuit Judges*, and WRIGHT, *Senior Circuit Judge*.

Opinion for the court *per curiam*.

PER CURIAM: Petitioners/appellants Investment Company Institute (ICI) and Securities Industry Association (SIA) challenge regulations of the Federal Deposit Insurance Corporation (FDIC) governing the activities of insured banks that are not members of the Federal Reserve System. Petitioners principally argue that insofar as FDIC regulations allow nonmember insured banks to have subsidiary or affiliate relationships with firms engaged in securities work, those regulations violate the command of § 21 of the Banking Act of 1933 (Glass-Steagall Act), 12 U.S.C. § 378 (1982), that securities firms shall not engage in receiving deposits "to any extent whatever." We cannot agree. The clear language of the Glass-Steagall Act demonstrates that Congress intended to differentiate between the activities of banks and the activities of banks' subsidiaries and affiliates. As we see no provision in the Act, including § 21, that prohibits subsidiaries or affiliates of nonmember insured banks from engaging in securities work, and because we find that petitioners lack standing to challenge the FDIC rule under §§ 6 and 8 of the Federal Deposit Insurance Act, 12 U.S.C. §§ 1816, 1818 (1982), we affirm the District Court's grant of summary judgment for the defendants.

see ICI v. *FDIC,* 606 F.Supp. 683 (1986), and dismiss the petition for review of the regulation.

I. BACKGROUND

Federal regulation effectively divides the United States commercial banking community into three major categories.[1] Banks that choose to become members of the Federal Reserve System fall under the jurisdiction of the Board of Governors of the Federal Reserve System. *See* 12 U.S.C. §§ 221, 248 (1982). National banks come within the jurisdiction of the Comptroller of the Currency. *See id.* §§ 1, 21. Finally, insured state banks that are not members of the Federal Reserve System operate under the watchful eye of the FDIC. *See id.* §§ 1811, 1815. Although the FDIC insures the deposits of all three categories, *id.* § 1811, it regulates directly only the third group. *See generally id.* § 1815. The Glass-Steagall Act seeks to draw a sharp line between the activities of these three categories of commercial banks and the activities of investment banks and other securities firms. *Id.* §§ 24, 78, 377, 378; *Board of Governors* v. *Investment Company Institute,* 450 U.S. 46, 63 (1981) ("Board of Governors").

This case explores the periphery of the separation of the banking and securities industries mandated by the Glass-Steagall Act. As the condition and character of the two industries have shifted over the past fifty years, the separation policy has shifted as well. Its changing shape has promoted particularly significant and protracted litigation in recent years, *see, e.g., Securities Industry Ass'n* v. *Board of Governors,* 468 U.S. 137 (1984) ("*Becker*") (commercial paper is a security under the Glass-Steagall Act); *Securities Industry Ass'n* v. *Board of Governors,* 468 U.S. 207 (1984) ("*Schwab*") (Board may allow bank holding company to acquire affiliate engaged in securities brokerage); *Securities Industry Ass'n v. Board of Governors,* ______ F.2d ______ (D.C. Cir. No. 86-5069, decided Dec. 23, 1986) (slip op. at 11)

1. A "fourth" category, consisting of the 27 Federal Savings Banks regulated by the Federal Home Loan Bank Board, is a much smaller element of the banking community. *See* Brief for Appellees/Respondents at 4; 12 U.S.C. § 1464(a) (1982).

(Board may allow banks to sell third-party commercial paper), and has prompted this court to call upon Congress to clarify its precise contours. *American Bankers Ass'n* v. SEC, 804 F.2d 739, 755-56 (D.C. Cir. 1986) (SEC has no authority to regulate securities activities of banks).

The specific issue presented here is the extent to which Congress intended to bar subsidiaries and affiliates of insured nonmember banks from engaging in the securities business. In September 1982 the FDIC published in the Federal Register a policy statement that found the Glass-Steagall Act "does not prohibit an insured nonmember bank from establishing an affiliate relationship with or organizing or acquiring a subsidiary corporation that engages in the business of issuing, underwriting, selling, or distributing stocks, bonds, debentures, notes, or other securities." 49 Fed. Reg. 46709 (Nov. 28, 1984); *see* 47 Fed. Reg. 38984 (Sept. 3, 1982). The FDIC did note, however, that the securities activities of such affiliates or subsidiaries might raise questions of "unsafe or unsound banking practices" and practices not "consistent with the purposes of" deposit insurance under §§ 8 and 6 of the Federal Deposit Insurance Act (FDIA), 12 U.S.C. §§ 1818, 1816 (1982). *Id.*[2]

In November 1984, after notice and comment proceedings, the FDIC adopted a final rule regulating the securities activities of affiliates and subsidiaries of insured nonmember banks under §§ 6 and 8 of the FDIA. 49 Fed. Reg. 46709 (Nov. 28, 1984), regulations *codified at* 12 C.F.R. § 337.4 (1986). Although the rule does not prohibit such securities activities outright, it does restrict that activity in a number of ways. Banks may only maintain "bona fide" subsidiaries that engage in securities work. The rule defines "bona fide subsidiary" so as to limit the extent to which banks and their securities affiliates and subsidiaries may share company names or logos, as well as places of business. 12 C.F.R. § 337.4(a) (2) (ii), (iii); 49 Fed. Reg. at 46710. The

2. Petitioners challenged the Policy Statement. Their suit was dismissed without prejudice, pending the outcome of FDIC's rulemaking process. *Investment Company Institute* v. *United States*, D. D.C. Civil Action No. 82-2532, filed September 8, 1982.

definition also requires banks and subsidiaries to maintain separate accounting records and to observe separate corporate formalities. 12 C.F.R. § 337.4(a) (2) (iv), (v). The two entities cannot share officers, and must conduct business pursuant to independent policies and procedures, including the maintenance of separate employees and payrolls. *Id.* § 337.4(a) (2) (vi), (vii), (viii); 49 Fed. Reg. at 46711-12. Finally, and perhaps most importantly, the rule requires a subsidiary to be "adequately capitalized." 12 C.F.R. § 337.4(a) (2) (i).

Petitioners Investment Company Institute and Securities Industry Association, representing mutual fund companies and investment bankers, simultaneously filed a petition for review in this court and an action to enjoin the regulation in the United States District Court for the District of Columbia. They argue that the rule violates § 21 of the Glass-Steagall Act, 12 U.S.C. § 378 (1982), and §§ 6 and 8 of the Federal Deposit Insurance Act. 12 U.S.C. §§ 1816, 1818 (1982). We stayed our proceedings until the District Court had ruled on the matter. Order of February 19, 1985. District Judge Gesell, on cross-motions for summary judgment, upheld the FDIC's regulations and dismissed the ICI and SIA action. *ICI* v. *FDIC*, 606 F.Supp 683 (D. D.C. 1985). We consider now both the appeal from that judgment (No. 85-5769) and the original petition for review of the FDIC rule (No. 84-1616).

II. PETITIONERS' STANDING UNDER THE GLASS-STEAGALL ACT AND THE FEDERAL DEPOSIT INSURANCE ACT

Before we address the merits of petitioners' challenge, we must examine the standing of securities industry plaintiffs to challenge the FDIC rule at issue. Although strict application of this circuit's standing test might leave petitioners' standing under Glass-Steagall in doubt, the Supreme Court has made clear that petitioners have standing in actions of this sort. Securities industry plaintiffs' standing under the Federal Deposit Insurance Act, however, is apparently a question of first impression. Faithful

application of this circuit's "zone of interests" analysis requires us to deny petitioners standing under that Act.

At the outset, we note that petitioners have shown sufficient "injury in fact" from these regulations for standing purposes. The FDIC will deal petitioners competitive injury by allowing insured nonmember banks to enter the securities field indirectly through subsidiaries and affiliates. *See, e.g., Hardin* v. *Kentucky Utilities Co.*, 390 U.S. 1, 6 (1967); *Chicago Junction Case*, 264 U.S. 258 (1924); *see also ICI* v. *FDIC*, 606 F.Supp. at 684 (FDIC regulation "plainly threatens" economic injury to securities firms). But the standing inquiry, of course, does not end with "injury in fact." Competitive injury alone does not confer standing. *Hardin*, 390 U.S. at 5-6. Once we find such injury, we must turn to the "prudential" or "zone of interests" standing test enunciated by the Supreme Court in *Data Processing Serv.* v. *Camp*, 397 U.S. 150, 153 (1970). If the interest the petitioner seeks to protect is "arguably within the zone of interests to be protected or regulated by the statute or constitutional guarantee in question," petitioner has standing.

This circuit has interpreted the "zone of interests" standing analysis to require some express indicia in the language of an act or its legislative history that Congress intended to protect the specific interest petitioner seeks to protect. *Control Data Corp.* v. *Baldrige*, 655 F.2d 283, 294-95 (D.C. Cir.) ("slight" express indicia sufficient), *cert. denied*, 454 U.S. 881 (1981). Several opinions of the court, however, have questioned whether this relatively stringent intent rule may be unduly narrow in light of the Supreme Court's rather expansive emphasis on the term "arguably" in its application of the prudential test. *See, e.g., Autolog Corp.* v. *Regan*, 731 F.2d 25, 29 n.2. (D.C. Cir. 1984); *American Friends Serv. Committee* v. *Webster*, 720 F.2d 29, 51 (D.C. Cir. 1983); *Copper & Brass Fabricators* v. *Department of the Treasury*, 679 F.2d 951, 954-55 (D.C. Cir. 1982) (Ginsburg, J., concurring).[3] Despite these expressions of concern, though,

3. Notably, a recent *per curiam* opinion of this court affirmed, over Judge (now Justice) Scalia's dissent, a District Court's application of a much looser "zone of interests" analysis. *See Securities Industry Ass'n* v. *Comptroller of*

the "slight indicia" approach to the prudential standing test at present remains the law of this circuit. *See Control Data; Copper & Brass Fabricators; Tax Analysts & Advocates* v. *Blumenthal*, 566 F.2d 130, 143 (D.C. Cir. 1977), *cert. denied*, 434 U.S. 1086 (1978); *Constructores Civiles de CentroAmerica, S.A.* v. *Hannah*, 459 F.2d 1183, 1188 (D.C. Cir. 1972).

A. *The Glass-Steagall Act*

We note briefly that it is difficult to find in the language or the legislative history of § 21 of the Glass-Steagall Act even such a "slight indicia" of congressional intent to protect the competitive position of the securities industry against banking industry encroachment. To the contrary, Congress seemed less interested in protecting the securities industry under § 21 than in using that provision to protect others *from* the securities industry. *See, e.g.*, 77 Cong. Rec. 3770 (May 19, 1933) (statement of Senator Glass, sponsor of the bill); 77 Cong. Rec. 4179 (May 25, 1933) (same); *Becker*, 468 U.S. at 148; *Board of Governors*, 450 U.S. at 63. After all, § 21's language specifically prohibits securities firms from accepting deposits, and does not primarily focus on controlling banking firms that do securities business.[4]

If this court were the first to consider petitioners' standing to challenge regulations under the Glass-Steagall Act, we would review the legislative history in somewhat greater detail in an effort to discover that "slight indicia" that Congress intended to protect the securities industry. But we are not the first court to examine this question. In *Investment Company Institute* v. *Camp*, 401 U.S. 617, 620-21 (1971), the Supreme Court held that securities industry groups had standing to challenge regulations promulgated under the Glass-Steagall Act that allowed

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the Currency, 758 F.2d 739 (D.C. Cir. 1985), *affirming* 577 F. Supp. 252 (D.D.C. 1984), *cert. granted sub nom. Clarke* v. *Securities Industry Ass'n*, 106 S.Ct. 1259 (1986).

4. Of course, § 21 also clearly bars banks from engaging in securities work directly, except to the extent authorized by § 16. *See Camp*, 401 U.S. at 625, 629. This does not alter the fact, however, that the language of the provision strongly emphasizes a prohibition against deposits received by securities firms.

national banks to enter the securities field. The Court concluded that in §§ 16 and 21 of the Act Congress "arguably" had legislated against the competition ICI sought to prevent. 401 U.S. at 620.

The FDIC distinguishes *Camp* from the case presently before the court by pointing out that ICI's challenge here rests on § 21 alone. Section 21 is a criminal provision, notes FDIC, and thus seeks to protect the *public interest*, not the interests of securities firms. Implicitly, FDIC argues that the *Camp* Court actually rested its standing determination on § 16, not § 21.

Although the FDIC's point on the criminal focus of § 21 is well taken, it does not adequately demonstrate that the present case is different from the situation in *Camp*. First of all, nothing in the *Camp* decision indicates that the Supreme Court meant to distinguish between § 16 and § 21 for standing purposes. 401 U.S. at 620. In fact, the Court's short standing discussion speaks of the two provisions in the same breath, and fails to draw any distinction whatever between them. *Id.* Second, even though § 21 does contain a criminal penalty element, FDIC's authority to interpret that section stems from purely civil enforcement powers. 12 U.S.C. § 1818 (1982). Section 21 has repeatedly and consistently received "civil" regulatory interpretation. *See, e.g., Becker,* 468 U.S. at 139; *Board of Governors,* 450 U.S. at 62. After all, the *Camp* case itself was purely civil in nature. 401 U.S. at 617-18, 639. In fact, petitioners assert, without contradiction by respondents, that no criminal action has *ever* been brought under the section. Supplemental Brief for Appellants/Petitioners at 11 n.* *.

Moreover, it is well established that courts applying the prudential standing test may look for the requisite protective intent on the part of Congress not only in the specific statutory provision at issue but also in other provisions of a statute, so long as those sections share an identity of purpose with the provision directly at issue. *Tax Analysts*, 566 F.2d at 141; *see also Autolog Corp.*, 731 F.2d at 30 n.3. As the Supreme Court has specifically indicated that § 16 and § 21 seek to "draw the same line," *Becker*,

468 U.S. at 149, we may appropriately look to § 16 to inform our standing decisions under § 21. In so doing, our analysis falls squarely within the Supreme Court's *Camp* holding that ICI has standing under § 16 and § 21 to challenge regulations allowing banks to enter the securities field. As a consequence, *Camp* controls. Petitioners' standing under § 21 of the Glass-Steagall Act to challenge these regulations is clear.

B. *The Federal Deposit Insurance Act*

Petitioner's standing under the FDIA is much less certain. Sections 6 and 8 of the FDIA speak in broad terms, forbidding bank practices that are not "consistent with the purposes" of federal deposit insurance or that are "unsafe and unsound." 12 U.S.C. §§ 1816, 1818 (1982). Neither provision expressly mentions the securities industry. In order to find that petitioners have standing under the FDIA, we must find some "slight indicia" in the Act that Congress meant to protect the securities industry. *Control Data*, 655 F.2d at 294-95.

Congress enacted the FDIA as part of the Banking Act of 1933, 48 STAT. 162, for the purposes of providing for "the safer use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations, and for other purposes * * *." H.R. Rep. 150, 73d Cong., 1st Sess. 1 (May 19, 1933). Nowhere in the text of the Act, or in the Conference Committee Report accompanying it, does Congress give any indication that it intended the FDIA to protect the securities industry. *See generally id.* No "slight indicia" of such intent is apparent in the debates leading to passage. *See, e.g.*, 77 Cong. Rec. 3686, 3750, 3834-42, 3904-47 (1933); *Control Data*, 655 F.2d at 294. Congress apparently was concerned only to protect bank depositors in order to foster renewed confidence in the Depression-shattered U.S. financial system. *See, e.g.*, 77 Cong. Rec. 3836-38 (May 20, 1933) (comments of Reps. Blanton and Steagall); *id.* at 3903 (May 22, 1933) (comments of Rep. Grover); *cf. id.* (comments of Rep. McGugin, favoring

protection of state banks). An intent to protect the competitive position of the securities industry is simply not to be found.

In an attempt to play down this fact, petitioners argue that because the Glass-Steagall Act and the FDIA were part of the same banking package, they share the same broad purposes. Reply Brief for Appellants/Petitioners at 3. Thus, if the Glass-Steagall Act "arguably protects" the securities industry, *see Camp*, 401 U.S. at 620-21, petitioners submit that the FDIA must do so as well. This circuit has held, however, that standing questions must be addressed on a provision-by-provision basis. *See Tax Analysts*, 566 F.2d at 140-41. As a consequence, petitioners' suggestion that we evaluate standing questions by broad, act-by-act comparisons must be rejected in favor of more particularized analysis. As we cannot find even "slight indicia" that Congress meant to protect the securities industry under §§ 6 and 8 of the FDIA, this circuit's *Control Data* analysis requires us to deny petitioners standing as injured competitors under that Act.[5]

The zone of interests test, however, speaks of both "protected" interests and "regulated" interests. *Data Processing*, 397 U.S. at 153. As just noted, petitioners fail the test on its "protected" prong. In anticipation of this outcome, petitioners also argue that because the FDIC regulation purports to limit securities firms' affiliations with banks, securities industry plaintiffs are directly regulated under the FDIA and therefore have standing to challange the rule under the test's "regulated" prong. *See* Reply Brief for Appellants/Petitioners at 4 n.7; *Data Processing*, 397 U.S. at 153. This argument places petitioners in an odd posture. Their position on the merits of the FDIC rule is not that the rule constitutes a harmful restriction on affiliation between banks and

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5. This result, so clearly dictated by this court's *Control Data* line of cases, is less clear when held up to the Supreme Court's analysis in *Data Processing*, 397 U.S. at 153, and *Arnold Tours* v. *Camp*, 400 U.S. 45, 46 (1970) (*per curiam*) ("In *Data Processing* we did not rely on any legislative history showing that Congress desired to protect data processors alone from competition."). Nevertheless, in light of the strength of the "slight indicia" approach in this circuit and the vagueness of the Surpeme Court's commands on the question, *see* text at pp. 6-7, we are bound to apply the *Control Data* analysis here.

securities firms. Rather, they argue that the rule causes competitive injury to their members because it does not ban *all* such affiliations outright.

Petitioners' "regulated party" zone of interests argument thus conflicts with their position on the merits and cannot form the basis for standing. They have failed to allege any injury in fact that stems from the rule's direct effect on their members. In order for petitioners to have standing as regulated parties, some logical, concrete link between harm alleged and the fact that *petitioners* are regulated is necessary.

Here, that link is absent, as a simple example makes clear. If the FDIC's rule merely recognized that banks can affiliate with securities firms, without imposing any restrictions whatever on that affiliation, competitive injury to petitioners would be greater than it is under the present rule. But though the competitive harm would be greater, petitioners obviously would not have standing as regulated parties. Conversely, if the rule *banned* such affiliations, competitive harm would vanish, but securities firms clearly would still be regulated. In other words, the FDIC rule's regulation of *securities firms* does not cause the competitive injury petitioners allege. The injury petitioners fear stems from the rule's effect on *banks*.

Granted, regulation of securities firms and regulation of banks are probably inseparable in a rule of this sort. But that is not to say that they are identical for the purpose of the "regulated" prong of the zone test. If petitioners were to allege the rule harmed them by restricting their own ability to compete with banks, they would have standing as parties whose freedom to act had been adversely affected by regulation. But in asserting standing as regulated parties on the basis of injury from the fact the rule allows *banks* to compete *too well*, petitioners demand stricter regulation of the banks and, incidentally, stricter regulation of themselves. Were petitioners otherwise within the zone of interests *protected* by the FDIA, this argument would be sufficient to confer standing. *See Barlow* v. *Collins*, 397 U.S. 159, 164 (1970) (farmers protected by Soil Conservation Act have

standing to challenge Agriculture Department rule granting farmers additional freedom to assign benefits from the Act, on basis of allegation that ability to assign benefits freely would place farmers at the mercy of creditors).

But the securities industry is not within the zone of interests the FDIA protects. As a consequence, since petitioners do not protest the rule's direct effect on their own activity, they simply are not "reliable private attorney[s] general to litigate the issues of the public interest in the present case," *Data Processing*, 397 U.S. at 154, and therefore do not have standing as regulated parties to challenge the rule's effect on banks' competitiveness. We see no reason to interpret the "regulated" prong of the zone test to create standing where, at base, the harm alleged stems from an agency's failure to regulate *another* party with sufficient stringency. *See Calumet Industries, Inc.* v. *Brock*, ______ F.2d ______ (D.C. Cir. No. 86-1203, decided Dec. 19, 1986).

For all these reasons, we find petitioners lack standing to challenge this FDIC rule under §§ 6 and 8 of the FDIA. Because securities industry plaintiffs do not fall within the "zone of interests" Congress sought to protect with the FDIA, petitioners have no standing as "protected" parties, and because they have not alleged any injury in fact that flows from the FDIC rule's direct regulation of their members, they have no standing as "regulated" parties.

III. THE GLASS-STEAGALL ACT CHALLENGE

Petitioners present a straightforward statutory argument. Section 21 of the Glass-Steagall Act makes it illegal:

> For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits * * *.

12 U.S.C. § 378(a)(1). Petitioners interpret the phrase "to any extent whatever" to bar insured nonmember banks from having subsidiaries or affiliates engaged in the securities business. FDIC responds that when Congress intended to bar subsidiary or affiliate relationships of this sort it clearly indicated that intent, and that in any event the court should defer to its reasonable interpretation.

A.

In weighing these competing interpretations of § 21 and the Glass-Steagall Act, we are bound by a venerable line of precedent counseling judicial deference toward an agency's evaluations of the statutes that give it legal life and authority. *See, e.g., NLRB* v. *Hearst Publications, Inc.*, 322 U.S. 111, 131 (1944); *Red Lion Broadcasting Co.* v. *FCC*, 395 U.S. 367, 381 (1969). That line of cases recently culminated in the Supreme Court's decision in *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), which established a simple two-part test, now familiar. If Congress has spoken clearly to the issue presented in a case, that intent controls. 467 U.S. at 844. If the agency's interpretation is contrary to the clear intent of Congress, the agency's interpretation is invalid. If, on the other hand, Congress had no clear intent as to the particular question at issue, the courts may invalidate the agency's interpretation only if it is "unreasonable" or "impermissible." *Id.* As we find in the present case that Congress clearly intended § 21 to allow insured nonmember banks to maintain subsidiary or affiliate relationships with securities firms, we uphold FDIC's interpretation of § 21 and affirm the District Court. Given this clear intent, we need not reach *Chevron's* "reasonableness" prong of analysis.

B.

Congress enacted the Glass-Steagall Act in response to the dramatic wave of bank failures of the early Depression, a wave that many perceived to have been the result of securities speculation by the banking industry. *See Board of Governors*, 450 U.S.

at 61 & n.28; *Camp*, 401 U.S. at 629-30. The Act seeks to separate the banking and securities industries "as completely as possible." *Board of Governors*, 450 U.S. at 70. But while Congress may have intended to build an insurmountable barrier between member banks of the Federal Reserve System and the securities industry, *see* 12 U.S.C. §§ 24, 78, 377 (1982), Congress was far from certain in 1933 that it had authority to effect such a sweeping separation for insured state nonmember banks. In fact, several members of Congress nervously commented during the debate leading to enactment of the bill that Congress might lack power to regulate nonmember banks at all. *See* 75 Cong. Rec. 9905 (May 10, 1932) (remarks of Sen. Walcott); *id.* at 9911, 9913-14 (remarks of Sen. Bulkley).

The hesitation of the 73rd Congress to regulate state nonmember banks is quite apparent in the actual language of the Act. National banks and banks that have chosen to become members of the Federal Reserve System are subject to stringent regulation that bars them from the securities field. Section 16 severely limits the ability of *national* banks to deal in securities, and bars them from underwriting securities. 12 U.S.C. § 24 (1982); *see also Securities Industry Ass'n* v. *Board of Governors*, ______ F.2d ______ (D.C. Cir. No. 86-5089, decided Dec. 23, 1986). Section 20 bars firms "principally" engaged in securities transactions from affiliating with *member* banks 12 U.S.C. § 377. Section 32 bars *member* banks from sharing officers or board members with securities firms. *Id.* § 78.

Only § 21 regulates both *member* and *nonmember* banks. Section 21 bars *any* "person, firm, corporation, association, business trust, or other similar organization" from engaging in securities business while receiving deposits "to any extent whatever." *Id.* § 378. It says nothing explicitly about the propriety of insured nonmember banks establishing subsidiaries or affiliates that engage in the securities business. Petitioners suggest, nevertheless, that Congress intended that the section prohibit such relationships.

This argument is difficult to support. If we read § 21 to prohibit insured nonmember banks from establishing securities subsidiaries or affiliates, the coherence of the the statute as a whole begins to crumble. Section 21 applies to both member and nonmember banks. If it prohibits all bank affiliate or subsidiary relationships with securities firms, then § 20's somewhat permissive language, which allows *member* banks to establish affiliate relationships with firms doing some limited amount of securities work, becomes meaningless. Accepting petitioners' interpretation, therefore, would require us to eliminate a provision of the statute, a clear violation of a fundamental canon of construction. *See National Insulation Transportation Committee* v. *ICC*, 683 F.2d 533, 537 (D.C. Cir. 1982); *In re Surface Mining Regulation Litigation*, 627 F.2d 1346, 1362 (D.C. Cir. 1980).

Petitioners play down this difficulty by arguing that § 20 constitutes a special exception for member banks to the general prohibition set out by § 21. Petitioners submit that although banks generally cannot maintain affiliate or subsidiary relationships with securities firms "to any extent whatever," § 20 specifically authorizes *member* banks to maintain such relationships with firms not "principally" engaged in securities work. *Nonmember* banks, however, cannot maintain such relationships. This explanation suffers from two readily apparent flaws.

First of all, Congress knew how to indicate that a section of the Act was intended as a specific exception to another section. Congress amended § 21 in 1935 to include language that expressly indicated that activities implicitly authorized under § 16 of the Act were not barred by § 21's broad language. Act of August 23, 1935, c. 614, § 303, 49 STAT. 707; *see also Securities Industry Ass'n* v. *Board of Governors*, ______ F.2d ______ (D.C. Cir. No. 86-5089, decided Dec. 23, 1986) (slip op. at 7) (discussing interplay between §§ 16 and 21). Congress has not done the same for § 20, and we see no basis whatever for inferring such intent. On the contrary, § 20 speaks in the language of prohibition, not authorization. Member banks "shall not be affiliated in any manner * * * with any corporation, association, business

trust, or other similar organization engaged principally" in securities activities. 12 U.S.C. § 377 (1982). Congress presumably did not indicate that § 20 should be an "exception" to § 21 because it did not intend that § 21 should extend to the activities of affiliates and subsidiaries in the first place. The two sections regulate separate activities.

Second, if we were to accept petitioners' argument that § 20 exempts member banks from the full prohibitory force of a § 21 that applies to both banks and their affiliates, we would be left with an anomalous result. Under petitioners' interpretation, *member* banks would be subject to *less* stringent § 21 regulation than would be insured *nonmember* banks. This outcome is dramatically counter to what we would expect on examination of the statute and its history. It seems clear that Congress felt its efforts to regulate nonmember banks rested on shaky, if not ramshackle, authority. Members of Congress explicitly discussed this problem as it pertained to regulation of nonmember bank affiliates, and specifically indicated that regulation of such affiliates was probably beyond the power of Congress.[6] That Congress would have imposed more demanding regulation on

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6. In fact, one passage seems nearly sufficient in itself to establish that Congress did not mean § 21 to extend to nonmember bank affiliates and subsidiaries:

> Mr. FESS. Earlier in the Senator's presentation he mentioned the fact that whether it be a national bank or a State bank, the control of affiliates does not extend outside of the Federal reserve set-up; that is, an affiliate of a State bank that is not a member of the Federal reserve system is not covered, is it?
>
> Mr. WALCOTT. Mr. President, there are state banks which exist now within the Federal reserve system, and they are member banks.
>
> Mr. FESS. Yes.
>
> Mr. WALCOTT. There are national banks within the Federal reserve system. Most of the national banks are under the Federal reserve system; so that, whether State or whether national, provided the bank is a member of the Federal reserve system and has an affiliate, that affiliate must be divorced within three years.
>
> Mr. FESS. The provision does not attempt to go beyond the Federal reserve system?

(footnote continued on next page)

nonmember banks than on member banks, given this uncertainty, seems utterly improbable. Absent clear evidence, we will not infer that Congress had such contrary, even irrational, intentions for the statute.

Despite petitioners' considerable efforts, then, the language and structure of the Glass-Steagall Act do not support the view that § 21 bars insured nonmember banks from maintaining affiliate or subsidiary relationships with securities firms. Section 21 on its face fails to prohibit such relationships, and any judicial inference of such a prohibition would be inconsistent with the overall structure of the Act. This reasoning standing on its own demonstrates not only that FDIC's interpretation of § 21 is "permissible" but, in fact, that it is the only valid approach.

Moreover, the Supreme Court's guidance on the proper scope of § 21 supports the agency's interpretation. In *Board of Governors* v. *Investment Company Institute*, 450 U.S. 46 (1981), the Supreme Court addressed the argument that § 21 applies to bank holding companies as well as to banks, and that as a consequence it bars bank holding company subsidiaries from engaging in securities work. The Court found that "the language of § 21 cannot be read to include within its prohibition separate organizations related by ownership with a bank, which does receive deposits." 450 U.S. at 58 n.24. As if this statement were not clear enough, the Court went on to emphasize that because § 20 specifically addressed the proper relationship between member banks and securities affiliates, "the structure of the Act reveals a congressional intent to treat banks separately from their affiliates. The reading of the Act urged by respondent [arguing for 'single entity' treatment of banks and their affiliates under § 21] would render § 20 meaningless." *Id.* And to lay the question to rest once and for all, the Court stated that under Glass-Steagall "bank

(footnote continued from previous page)

Mr. WALCOTT. It does not control State banking, and the reason for that is obvious: The Federal Government has no jurisdiction over State banks.

75 Cong. Rec. 9905 (May 10, 1932), *quoted in* 606 F. Supp. at 686 n.6. District Judge Gesell described this discussion as "unequivocal," and we are hard-pressed to disagree.

affiliates may be authorized to engage in certain activities that are prohibited to banks themselves." *Id.* at 60. In light of our reasoning above, this language clearly guides the proper holding on the issue presented in this case. The agency's interpretation of § 21 is entirely consistent with Congress' intent, and must stand.

C.

Petitioners put forward no direct response to the Supreme Court's analysis in *Board of Governors.* Instead, they argue that the FDIC's rule is at odds with "the legislative purpose underlying Section 21." Brief for Appellants/Petitioners at 21. This is not a legislative history argument aimed at proving that the express terms of § 21 actually do bar nonmember bank activities of the sort the petitioners challenge. Rather, petitioners' argument merely adverts to the general policy objectives of the Glass-Steagall Act and attempts to demonstrate that those policies are thwarted, or at least are not furthered, by the FDIC rule at issue here. *Id.* at 27-33.

Petitioners' policy arguments can carry but little weight in a judicial forum. Our duty as a court is to interpret the banking laws, not to set national banking policy on the basis of general objectives set out by Congress. *See, e.g., American Bankers Ass'n*, 804 F.2d at 749. Petitioners have failed to demonstrate that Congress' intent in this provision is unclear. Even if they had, and if every policy objection they raise were irrefutable, we could not overturn FDIC's regulation unless the face of the statute and its legislative history demonstrated that FDIC's interpretation was "impermissible" or "unreasonable." *Chevron*, 467 U.S. at 843-44. Petitioners' "legislative purpose" arguments do not take this approach, however. They focus on policy alone. As the Supreme Court recently stated, "When a challenge to an agency construction, fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left by Congress, the challenge must fail." *Chevron*, 467 U.S. at 866. It is not our place to implement congressional policy in ways Congress itself fails to pursue.

Board of Governors v. *Dimension Financial Corp.*, 106 S. Ct. 681, 688-89 (1986); *TVA* v. *Hill*, 437 U.S. 153, 194-95 (1978). Congressional intent for § 21 is clear, and FDIC's interpretation is in line with that intent. We need go no further to uphold FDIC's view of the matter.

IV. CONCLUSION

Petitioners have standing to challenge these FDIC regulations under the Glass-Steagall Act, but do not have standing under the FDIA for that purpose. As the FDIC has demonstrated that its rule is consistent with the clear intent of Congress in the Glass-Steagall Act, we affirm the District Court's grant of summary judgment in No.85-5769, and dismiss the petition for review in No.84-1616.

So ordered.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

INVESTMENT COMPANY INSTITUTE,
ET AL.,
Plaintiffs,

v.

FEDERAL DEPOSIT INSURANCE
CORPORATION, ET AL.,
Defendants.

Civil Action No. 84-3875

ORDER

Upon consideration of the parties' cross-motions for summary judgment, the briefs and arguments of counsel, and the entire record herein, for reasons stated in an accompanying Memorandum, it is hereby

ORDERED that plaintiffs' motion for summary judgment is denied; and it is further

ORDERED that defendants' motion for summary judgment is granted; and it is further

ORDERED that the complaint is dismissed with prejudice.

/s/ GERHARD A. GESELL
UNITED STATES DISTRICT JUDGE

APRIL 23, 1985

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

INVESTMENT COMPANY INSTITUTE, ET AL., *Plaintiffs*, v. FEDERAL DEPOSIT INSURANCE CORPORATION, ET AL., *Defendants.*	Civil Action No. 84-3875

MEMORANDUM

This case concerns an interpretation of the Glass-Steagall Act that the Federal Deposit Insurance Corporation (FDIC) has implemented through regulations[1] permitting state banks insured by the FDIC that are not members of the Federal Reserve System to own affiliated subsidiaries engaged in the securities business. Plaintiffs are trade associations representing mutual fund companies and investment bankers that would compete with the security affiliates of such banks.[2] To test the legality of the FDIC's actions, the parties have filed cross-motions for summary judgment, which have been fully briefed and argued.[3]

The regulations issued by the FDIC are designed to govern the manner in which insured non-member state banks can arrange to own subsidiaries and affiliates engaged in aspects of the securities business, particularly underwriting various types of securities. The regulations announce and assume that the Glass-Steagall Act does not bar such a relationship between an insured non-member bank and its security subsidiary or affiliate but proceed

1. The regulations were finally adopted by the FDIC on November 19, 1984. *See* 49 Fed. Reg. 46,709 (Nov. 28, 1984), *to be codified at* 12 C.F.R. § 337.4.

2. There are approximately 9,000 state-chartered FDIC-insured banks that are not members of the Federal Reserve System.

3. *Amicus* briefs supporting the FDIC were filed by the Dealer Bank Association and the American Bankers Association.

to control aspects of that relationship. The regulations rely on the FDIC's power, granted by the Federal Deposit Insurance Act, to prohibit unsafe and unsound banking practices. 12 U.S.C. § 1818(a). Plaintiffs do not seriously challenge the detailed terms of these regulations. Rather, they simply maintain that the regulations as a whole are illegal because the Glass-Steagall Act prohibits any securities activity by state insured non-member banks, whether directly or through subsidiaries and affiliates.

Since defendants have moved alternatively to dismiss the complaint on the ground that plaintiffs lack standing, that threshold issue must be resolved before considering the merits.

Plaintiffs' claim of injury is straightforward: they claim their members will be hurt competitively if the FDIC allows insured non-member state banks to set up subsidiaries and affiliates to compete with plaintiffs' members. Because in their view such competition is illegal and barred by Section 21 of the Glass-Steagall Act, 12 U.S.C. § 378(a)(1), they assert they are within the "zone of interests" protected by the Act. In another case where plaintiffs' members challenged a banking regulator's interpretation of the Glass-Steagall Act to their disadvantage, the Supreme Court found plaintiffs' members within the Act's zone of interests. *Investment Co. Institute* v. *Camp*, 401 U.S. 617, 620-21 (1971).[4]

The FDIC's argument against standing seeks to parse plaintiffs' alleged competitive injury into two parts and then separately to defeat each.

First, the FDIC argues that plaintiffs are only challenging the FDIC's interpretation of the Glass-Steagall Act, which merely states the agency's opinion that insured non-member state banks are not barred by the Act from establishing subsidiaries and affiliates to engage in securities underwriting and other transactions. The agency thus claims plaintiffs are seeking merely an advisory opinion from the Court on the correctness of the

4. Defendants criticize the *Camp* zone of interests rationale at great length but of course concede this Court must follow *Camp*, which has been repeatedly relied on by the United States Court of Appeals for the District of Columbia Circuit and the Supreme Court.

agency's view. Second, the FDIC asserts plaintiffs suffer no economic injury from the regulations themselves because those regulations do not open the door to competition with plaintiffs' members but merely partially close a door already open.

The validity of this argument, of course, is premised on the correctness of the FDIC's view that the door is already in fact open. The FDIC cannot so easily divide and conquer plaintiffs' standing. The FDIC's challenged act must be examined as a whole, not in its pieces. As a whole, the agency action coupling its interpretation of the Glass-Steagall Act with regulations implementing that interpretation plainly threatens economic injury to securities firms and provides standing to plaintiffs. The Court thus must address the merits of the complaint.

Section 21 of the Glass-Steagall Act provides in pertinent part:

> [I]t shall be unlawful—(1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor: *Provided*, That the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities to the extent permitted to national banking associations by the provisions of section 24 of this title . . . .

12 U.S.C. § 378(a)(1). Under section 24, national banks, with limited specific exceptions, are barred from engaging in securities transactions for their own account. 12 U.S.C. § 24 (Seventh). Neither section specifically mentions affiliates or subsidiaries. Section 20 of the Act bars affiliations between banks and securities firms but is expressly limited to banks that are members of the Federal Reserve system. 12 U.S.C. § 377. Similarly, section 32

of the Act—also limited to member banks—bars officers, directors or employees of security underwriting firms from being officers, directors or employees of banks at the same time, with certain exceptions. 12 U.S.C. § 78.

The parties agree that section 21 prohibits insured non-member state banks from engaging directly in the securities business. They disagree as to whether it also prohibits affiliates and subsidiaries of such banks from conducting a security business.

Section 21 is silent as to the activities of bank subsidiaries and affiliates. Plaintiffs argue that the bar in the section's first clause prohibiting security companies from taking deposits "to any extent whatever" by implication prevents banks from having security subsidiaries and affiliates.

Section 21 is a criminal statute, 12 U.S.C. § 378(b).[5] It must be strictly construed. *E.g., Dunn* v. *United States*, 442 U.S. 100, 112-13 (1979). Plaintiffs' reading of the section violates this rule of construction. Beyond this, another rule of construction requires courts to give meaning to every part of a statute and to reject interpretations that render related sections surplusage or contradictory. *See In re Surface Mining Regulation Litigation*, 627 F.2d 1346, 1362 (D.C. Cir. 1980). Under plaintiffs' interpretation of section 21, the prior section, section 20, becomes surplusage. That section forbids member banks from forming controlling affiliations with companies engaged in securities underwriting and similar activities. 12 U.S.C. § 377. Because plaintiffs read section 21 as forbidding any affiliations at all, controlling or not, between either member or non-member banks and securities firms, section 20 would become unnecessary and contradictory.

Plaintiffs try to avoid this awkward spot by reading section 20 as permissive rather than prohibitory. They contend that while section 21 has taken away any right of affiliation for both member

5. Because it is a prohibitory, not regulatory, statute, the FDIC has no authority to make exceptions to its ban by regulation. The FDIC contends it has not done so here but has only exercised its authority to control unsafe and unsound banking practices.

and non-member banks, section 20 gives back some right of non-controlling affiliation to member banks.

There are two answers to this. First, the plain words of the statute are prohibitory, not permissive: "no member bank shall be affiliated . . . ." 12 U.S.C. § 377. Second, legislative history squarely indicates that Congress intended to place controls on the affiliations only of banks belonging to the Federal Reserve System and did not intend to restrict affiliations of state non-member banks because at time of enactment 50 years ago it doubted Congress could exercise federal authority over state-chartered banks not within the Federal Reserve System. *See* 75 Cong. Rec. 9905 (May 10, 1932) (remarks of Sen. Walcott);[6] *id.* at 9911, 9913-14 (remarks of Sen. Bulkley).

As the Supreme Court has recognized, other legislative history of the Glass-Steagall Act shows that Congress intended to treat banks separately from companies affiliated by ownership with banks. *See Board of Governors of Federal Reserve System* v. *Investment Co. Institute*, 450 U.S. 46, 58 n.24, 60 (1981).

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6. The dialogue between Senators Fess and Walcott on this issue is unequivocal:

> Mr. Fess. Earlier in the Senator's presentation he mentioned the fact that whether it be a national bank or a State bank, the control of affiliates does not extend outside of the Federal reserve set-up; that is, an affiliate of a State bank that is not a member of the Federal reserve system is not covered, is it?
>
> Mr. Walcott. Mr. President, there are State banks which exist now within the Federal reserve system, and they are member banks.
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> Mr. Fess. Yes.
>
> Mr. Walcott. There are national banks within the Federal reserve system. Most of the national banks are under the Federal reserve system; so that, whether State or whether national, provided the bank is a member of the Federal Reserve system and has an affiliate, that affiliate must be divorced within three years.
>
> Mr. Fess. The provision does not attempt to go beyond the Federal reserve system?
>
> Mr. Walcott. It does not control State banking, and the reason for that is obvious: The Federal Government has no jurisdiction over State banks.

75 Cong. Rec. 9905.

While neither the Supreme Court nor any other court has confronted the issue presented by this case,[7] the legislative history, the statutory language and structure, and common sense all run counter to plaintiffs' position.

The Court finds that section 21 was not intended to bar securities activities by subsidiaries or affiliates of insured non-member state banks. While Congress recognized the possible evils involved in such affiliations, it expressly addressed them in other sections of the Act but deliberately chose not to intrude upon state non-member banks in this respect. 12 U.S.C. §§ 78, 377.

FDIC's interpretation of section 21 is sustained. To the extent its regulations tend to keep state non-member insured banks and security affiliates apart, plaintiffs cannot complain. Any lessening of the effectiveness of legal competition gives these particular plaintiffs no ground to claim injury. Indeed, the complaint raises no substantial issue as to the validity of the FDIC's regulation other than plaintiffs' premise that insured non-member state banks cannot affiliate with security companies. Thus the plaintiffs' motion for summary judgment is denied and the defendants' motion for summary judgment is granted. An appropriate Order is filed herewith.

/s/ Gerhard A. Gesell

UNITED STATES DISTRICT JUDGE

April 23, 1985

7. Plaintiffs' attempt to draw broad meaning from the Supreme Court's recent decision in *Securities Industry Ass'n* v. *Board of Governors*, 104 S.Ct. 2979 (1984) (*Becker*), fails for this reason. *Becker* did not address the affiliate issue at all.

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLUMBIA

INVESTMENT COMPANY INSTITUTE,
1600 M Street, N.W., Suite 600
Washington, D.C. 20036
Tel. (202) 293-7700

and

SECURITIES INDUSTRY ASSOCIATION,
120 Broadway
New York, New York 10271
Tel. (212) 425-2700

Plaintiffs,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, an agency of the United States,
550 17th Street, N.W.
Washington, D.C. 20429
Tel. (202) 393-8400

and

WILLIAM M. ISAAC, as Chairman of the Board of Directors of the Federal Deposit Insurance Corporation,
550 17th Street, N.W.
Washington, D.C. 20429
Tel. (202) 393-8400

and

C. T. CONOVER and IRVINE H. SPRAGUE, as Members of the Board of Directors of the Federal Deposit Insurance Corporation,
550 17th Street, N.W.
Washington, D.C. 20429
Tel. (202) 393-8400

and

THE UNITED STATES OF AMERICA,

Defendants.

Civil Action No. 84-3875

COMPLAINT

(For Injunctive and Declaratory Relief)

Nature of the Action, Jurisdiction and Venue

1. In 1933, Congress determined that "the mere existence of a [bank] securities operation, 'no matter how carefully and conservatively run, is inconsistent with the best interests' of the bank as a whole." *Securities Industry Association* v. *Board of Governors of the Federal Reserve System,* 104 S. Ct. 2979, 2991-92 (1984). To give effect to this considered legislative judgment, Congress enacted the Glass-Steagall Act, 12 U.S.C. §§ 24 (Seventh), 78, 221a, 335, 377, 378, in order to exclude banks from virtually all aspects of the securities business. On November 28, 1984, however, the Federal Deposit Insurance Corporation ("FDIC") and its individual directors, in direct contravention of the longstanding expression of national policy embodied in the Glass-Steagall Act, issued a final rule ("Rule") declaring that the Act permits the nation's 9,000 FDIC-insured banks which are not members of the Federal Reserve System ("insured nonmember banks") to engage indirectly in any and all aspects of the securities business. The issuance of the Rule was intended to, and will in fact, have the effect of facilitating and encouraging the unlawful entry of insured nonmember banks into the securities business. Plaintiffs Investment Company Institute (the "Institute") and Securities Industry Association ("SIA") are adversely affected, aggrieved, and irreparably injured by the FDIC's Rule.

2. This action seeks a declaratory judgment that the Rule is arbitrary, capricious, an abuse of discretion, and otherwise not in accordance with law.

3. This action also seeks a permanent injunction ordering the FDIC and its individual directors to withdraw the Rule and to give the Rule no force and effect.

4. This action arises under various laws of the United States, including, among others, the Administrative Procedure Act, 5 U.S.C. §§ 551, *et seq.*; the Declaratory Judgment Act, 28 U.S.C.

§§ 2201, *et seq.*; the Glass-Steagall Act, 12 U.S.C. §§ 24 (Seventh), 78, 221a, 335, 377, 378; the Financial Institutions Supervisory Act, 12 U.S.C. § 1818; and the Federal Deposit Insurance Act, 12 U.S.C. §§ 1811, *et seq.*

5. Jurisdiction is conferred upon this Court by 28 U.S.C. §§ 1331, 1337 and 1346(a)(2). Venue properly lies in this district pursuant to 28 U.S.C. §§ 1391(b) and (e).

The Parties and Related Persons

6. The Institute is a non-profit association incorporated in the State of Delaware with its principal place of business in Washington, D.C. The Institute is the national association of open-end investment companies (commonly known as mutual funds), their investment advisers, and their principal underwriters. The Institute has more than 1100 investment company members, with approximately 16 million shareholders and assets in excess of $300 billion. The Institute brings this suit in a representative capacity on behalf of all its members.

7. The SIA is an association incorporated in the State of Delaware and having its principal place of business in the City of New York in the State of New York and having an office in Washington, D.C. The SIA is a national trade association representing approximately 500 organizations responsible for over 90 percent of the investment banking business of the nation, for which it sues in a representative capacity. Its membership is a cross section of the securities industry: the business of its members includes, *inter alia*, retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, including the distribution and trading of a wide range of securities. The firms which comprise the SIA's membership are located across the nation and provide services to investors of every size and type.

8. The defendant FDIC is a duly constituted agency of the United States, created by the Federal Deposit Insurance Act of 1933, 12 U.S.C. §§ 1811, *et seq.*, and charged with the responsibility of administering, enforcing, and regulating the activities of

insured nonmember banks. The FDIC is an "agency" within the meaning of the Administrative Procedure Act, 5 U.S.C. § 551(2).

9. The defendant William M. Isaac is Chairman of the Board of Directors of the FDIC. Defendants C. T. Conover and Irving H. Sprague are members of the Board of Directors of the FDIC. All individual directors are named herein in their official capacities.

The Rulings of the FDIC Authorizing, Facilitating and Encouraging the Securities Activities of Insured Nonmember Banks

10. The administrative process culminating in the issuance of the Rule under challenge here began in 1982, when the Boston Five Cents Savings Bank took steps to engage in the mutual fund business, and when the Washington Mutual Savings Bank took steps to engage in the mutual fund and securities brokerage businesses, through wholly owned subsidiaries. In response to these actions, the Institute and the SIA petitioned with the FDIC to halt the banks' activities, demonstrating that they violated not only the Glass-Steagall Act, but also a variety of other federal and state laws, including the Financial Institutions Supervisory Act and the Federal Deposit Insurance Act.

11. The FDIC responded to the petitions by, among other things, issuing a Policy Statement on August 23, 1982. The Policy Statement announced that, even though the Glass-Steagall Act flatly prohibits insured nonmember banks from engaging directly in the business of issuing, underwriting, selling, or distributing stocks, bonds, debentures, notes and other securities, the Act nonetheless permits insured nonmember banks to engage in any and all aspects of the securities business indirectly.

12. At the same time, the FDIC conceded that its Policy Statement created the potential for the very sort of conflicts of interest, financial dangers, and other hazards that prompted Congress to enact the Glass-Steagall Act and to exclude all banks, including insured nonmember banks, from the securities business.

The FDIC accordingly issued an Advance Notice of Proposed Rulemaking on September 20, 1982, soliciting comments on whether the agency should commence rulemaking proceedings to regulate the very securities activities its Policy Statement had just authorized. The Institute and the SIA filed written comments on the FDIC's Advance Notice of Proposed Rulemaking, urging the FDIC, among other things, to retract its administrative Policy Statement and strictly to enforce the terms of the Glass-Steagall Act.

13. On May 17, 1983, the FDIC issued a proposed rule which reaffirmed its decision to permit insured nonmember banks to engage in the securities business. The proposed rule also solicited comments upon a variety of restrictions proposed by the agency in an attempt to ameliorate the resulting dangers to insured nonmember banks and their depositors.

14. On June 17, 1983, the FDIC held a public hearing on its proposed rule. In a formal oral presentation, the Institute explained that the FDIC's decision to authorize and then regulate the securities activities of insured nonmember banks was inconsistent with the terms, structure and policy of the Glass-Steagall Act. The Institute also demonstrated that the restrictions contained in the FDIC's proposed rule were wholly inadequate to achieve their ostensible purpose, since the restrictions failed to prevent the hazards that Congress determined inevitably to arise when the banking and securities businesses are combined.

15. The SIA and the Institute submitted written comments further addressing the FDIC's proposed rule in detail on July 15, and July 18, 1983, respectively.

16. On May 1, 1984, the FDIC reproposed its rule for further public comment. In effect conceding that the agency's unfamiliarity with the operations of, and the legal framework governing, the nation's securities markets had seriously flawed its original rule proposal, the agency promulgated a new proposed rule. The new proposed rule revised, rescinded, and added to the restrictions contained in the original proposed rule, all in an effort to

mitigate the dangers flowing from the securities activities the agency had authorized.

17. The SIA and the Institute submitted written comments on the FDIC's new proposed rule, on May 29, and May 31, 1984, respectively. The SIA and the Institute again reiterated that the proposed rule contravened the terms, structure and policy of the Glass-Steagall Act. The SIA and the Institute also demonstrated that the restrictions set forth in the new proposed rule still failed to ameliorate the hazards that prompted Congress to enact flat statutory prohibitions excluding banks from the securities business.

18. On November 19, 1984, the FDIC voted to adopt the final Rule under review here. The Rule reaffirms the FDIC's determination that the Glass-Steagall Act permits insured nonmember banks to engage in the securities business indirectly, while conceding that the combination of commercial and investment banking authorized by the agency will give rise to all the hazards that Congress enacted the Glass-Steagall Act to eradicate. The Rule attempts to cabin these dangers through yet another, further revised set of administrative restrictions. The restrictions contained in the Rule, however, do not suffice to eliminate the hazards that Congress itself determined, over fifty years ago, to be so pervasive and so subtle as to be impervious to administrative regulatory control.

19. On November 28, 1984, the Rule was published in the Federal Register. The Rule becomes effective, by its terms, on December 28, 1984.

Violations of the Administrative Procedure Act

20. The Administrative Procedure Act (the "APA") provides, among other things, that agency action which is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law," is unlawful and should be set aside. 5 U.S.C. § 706(2)(A).

21. The Glass-Steagall Act makes it unlawful for any bank to engage to any extent whatever in the business of issuing, underwriting, selling, or distributing stocks, bonds, debentures, notes or other securities. 12 U.S.C. §§ 24 (Seventh), 78, 221a, 335, 377, 378.

22. The FDIC's Rule permitting insured nonmember banks to engage in all aspects of the securities business indirectly is arbitrary, capricious, and abuse of discretion, and otherwise not in accordance with law because, among other things, the Glass-Steagall Act flatly prohibits insured nonmember banks from engaging in virtually all areas of securities business, whether directly or indirectly.

23. Section 202 of the Financial Institutions Supervisory Act prohibits all insured nonmember banks from engaging in any "unsafe and unsound [banking] practices." 12 U.S.C. § 1818(b).

24. The FDIC's Rule also is arbitrary, capricious, an abuse of discretion, and otherwise not in accordance with law because, among other things, the combination of banking and securities businesses sanctioned by the FDIC's Rule is inherently "unsafe and unsound," notwithstanding the restrictions placed upon the securities activities of insured nonmember banks by the FDIC's Rule.

25. Section 6 of the Federal Deposit Insurance Act, 12 U.S.C. § 1816, forbids the FDIC to grant deposit insurance to any bank whose powers are not "consistent with the purposes" of the Act.

26. The FDIC's Rule also is arbitrary, capricious, an abuse of discretion and otherwise not in accordance with law because the Rule empowers insured nonmember banks to engage in securities activities which are not "consistent with the purposes" of the Federal Deposit Insurance Act.

<u>Injury to the Institute, the SIA and Their Members</u>

27. The FDIC's Rule permitting insured nonmember banks unlawfully to enter into the securities business indirectly will have

an immediate, serious and detrimental impact upon the members of the Institute, of the SIA, and of the public. Among other things, as a direct and immediate result of the FDIC's Rule, insured nonmember banks will, upon information and belief, devise and implement plans unlawfully to compete with the members of the Institute and of the SIA by entering the mutual fund and securities businesses indirectly in violation of federal law. This unlawful activity will subject the members of the Institute and of the SIA to unlawful competition, will deprive them of legitimate business, and will dilute, divert and withdraw a substantial portion of the market for their services to the substantial and irreparable injury of the members of the Institute and the SIA. Moreover, the FDIC's Rule and the ensuing illegal activities of insured nonmember banks will give rise to all the conflicts of interests, financial hazards and other dangers that prompted Congress to enact the Glass-Steagall Act and to exclude banks from the securities business.

28. The FDIC's Rule and the unlawful entry of the insured nonmember banks into the securities business will have the further irreparable effects of (1) undermining depositor and public confidence in banks whose deposits are insured by the FDIC; (2) subjecting the FDIC insurance funds to risks never intended or envisioned by Congress; (3) prompting a potential exodus by member banks from the Federal Reserve System in order to take advantage of the new securities powers the Rule authorizes to insured nonmember banks; (4) creating instability in the nation's banks and financial system; and (5) exposing those insured nonmember banks which enter the securities business in accordance with the Rule to the risks of an unfamiliar business.

29. An actual controversy exists between the parties. The Institute and the SIA have exhausted whatever administrative remedies may be available to them and have no adequate remedy at law.

30. The Institute, the SIA and their members will be irreparably injured unless this Court enters permanent injunctive relief

ordering the FDIC and its individual directors to withdraw the Rule and to give the Rule no force and effect.

WHEREFORE, the plaintiffs pray that the Court enter judgment as follows:

1. Declaring that the FDIC's rule is arbitrary, capricious, an abuse of discretion, and otherwise not in accordance with law, and that the Rule is, therefore, null and void.

2. Permanently enjoining the FDIC and its individual directors, as well as their successors, agents, employees, representatives and others acting in concert with them, to withdraw the Rule and to give it no force and effect.

3. Granting the Institute and the SIA their costs and attorney fees, as well as such additional and further relief as the Court deems just and proper.

Respectfully submitted,

/s/ HARVEY L. PITT

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Date: December 20, 1984
Washington, D.C.

Federal Register/Vol. 49, No. 230/Wednesday, November 28, 1984
Rules and Regulations/46,709

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 337
Unsafe and Unsound Banking Practices

AGENCY: Federal Deposit Insurance Corporation ("FDIC").

ACTION: Final rule.

SUMMARY: The FDIC has determined that it is not unlawful under the Glass-Steagall Act for an insured nonmember bank to establish or acquire a bona fide subsidiary that engages in securities activities nor for an insured nonmember bank to become affiliated with a company engaged in securities activities if authorized under state law. At the same time, however, the FDIC has found that some risk may be associated with those activities. In order to address that risk the FDIC is amending its regulations to (1) define bona fide subsidiary, (2) require notice of intent to invest in a securities subsidiary, (3) limit the permissible securities activities of insured nonmember bank subsidiaries, and (4) place certain other restrictions on loans, extensions of credit, and other transactions between insured nonmember banks and their subsidiaries or affiliates that engage in securities activities.

EFFECTIVE DATE: December 26, 1984.

FOR FURTHER INFORMATION CONTACT: Pamela E.F. LeCren, Senior Attorney, Legal Division, (202-389-4171), Room 4126 E. 550 17th Street, NW., Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION: On August 23, 1982, the Board of Directors of the FDIC adopted a policy statement concerning the applicability of the Glass-Steagall Act to securities activities of subsidiaries of nonmember banks. The policy

statement, which was published in the Federal Register on September 3, 1982 (47 FR 36984), concluded that, in the opinion of the Board of Directors, the Banking Act of 1933 (popularly known as the Glass-Steagall Act and codified in various provisions of title 12 of the United States Code) does not prohibit an insured nonmember bank from establishing an affiliate relationship with or organizing or acquiring a subsidiary corporation that engages in the business of issuing, underwriting, selling or distributing stocks, bonds, debentures, notes, or other securities. Although the policy statement was not designed to address the safety and soundness of such activities, it did state that the FDIC recognized its ongoing responsibility to ensure the safe and sound operation of insured nonmember banks and that, depending on the facts, potential risks can be presented by a bank subsidiary's involvement in particular securities activities.

In keeping with that statement, the FDIC on September 20, 1982 adopted an Advance Notice of Proposed Rulemaking (47 FR 42121) designed to solicit comment on the need, if any, for rulemaking with regard to securities activities of affiliates and subsidiaries of insured nonmember banks. After carefully reviewing the comments received in response to that notice, the FDIC adopted on May 9, 1983 a proposed regulation (May 1983 proposal) addressing the securities activities of subsidiaries and affiliates of insured nonmember banks. The basic features of the May 1983 proposal were as follows: (1) A requirement that a bank give FDIC notice of intent to invest in a securities subsidiary; (2) a prohibition on an insured nonmember bank establishing or acquiring a subsidiary that underwrites securities unless the underwriting activity is done on a best-efforts basis, is the underwriting of top rated debt securities, and/or is the underwriting of a money market type mutual fund; (3) a limit on the bank's investment in one or more securities subsidiaries to twenty percent of the bank's equity capital; (4) a limit on the amount of loans or other extensions of credit the bank can make to its securities subsidiary or affiliate; (5) a prohibition on the bank making loans to any customer where the purpose of the loan is to

acquire securities currently being underwritten or distributed by the bank's subsidiary or affiliate or accepting such securities as collateral on a loan or other extension of credit; (6) a prohibition on the bank directly or indirectly making loans or other extensions of credit to companies whose securities are currently being underwritten or distributed by the bank's subsidiary or affiliate if those securities are not rated in the top four rating categories by a nationally recognized rating service; (7) a prohibition on the bank as trustee purchasing in its sole discretion any security currently being underwritten, distributed, or issued by the bank's subsidiary or affiliate or any security currently being underwritten, distributed, or issued by any investment company advised by the bank's subsidiary or affiliate; and (8) a prohibition on the bank transacting business through its trust department with the bank's securities subsidiary or affiliate unless the transactions are comparable to transactions with an unaffiliated securities company.

Additionally, the May 1983 proposal defined the term "bona fide subsidiary" as a subsidiary of an insured nonmember bank that at a minimum (i) is adequately capitalized; (ii) is physically separate in its operations from the operation of the bank; (iii) maintains separate accounting and other corporate records; (iv) observes separate formalities such as separate board of directors meetings; (v) maintains separate employees who are compensated by the subsidiary; and (vi) conducts business separately from, functions independently of, and is not identified with, the banking business of the insured nonmember bank.

The May 1983 proposal was published for a sixty-day comment period which ended on July 18, 1983. In addition to inviting written comments during that time period, the FDIC invited oral testimony at a one-day public hearing that was held on June 17, 1983. The FDIC received 35 written comments and heard oral testimony from two witnesses at the June 17 public hearing. Because of the complexity of the issues involved and the relatively small number of comments received during the comment period, the FDIC issued a revised proposed regulation dealing with the

same subject matter on May 1, 1984 (49 FR 18497). The new proposed regulation was formulated after carefully reviewing the written comments on the May 1983 proposal as well as testimony given before various congressional committees that was given directly in connection with, or was relevant to, FDIC's rulemaking. The revised proposal, which is detailed below, was issued for a thirty-day comment period during which FDIC received 22 comments. Those comments are summarized below where relevant to an explanation of the final regulation.

Of the total of fifty-nine comments received during both comment periods, twelve were totally opposed to FDIC pursuing the rulemaking. Of the twelve comments opposing the rulemaking, two that were received during the 30-day comment period resubmitted comments which had been filed with the FDIC in response to the May 1983 proposal. The basis for the objections to the rulemaking included the following: (1) The proposal is beyond FDIC's authority, (2) the proposal is contrary to the Glass-Steagall Act, (3) action with regard to this area is best left to the states, (4) FDIC should let Congress deal with the question, (5) there is no need for a regulation in the area, (6) the proposal will not produce and benefits, (7) securities activities are inherently unsafe and unsound and banks should not be exposed to those risks at all, (8) the proposal will cause a mass exodus from the Federal Reserve System, and (9) at the most, the FDIC should issue a policy statement concerning insured nonmember bank indirect involvement in securities activities and not a regulation.

The FDIC acknowledges these comments but has determined to go forward with the rulemaking. FDIC is not attempting to usurp the prerogative of the state supervisors to regulate insured state nonmember banks nor the right of Congress to define the proper scope of a bank's direct and indirect securities activities under the Glass-Steagall Act. FDIC is merely seeking to fulfill its statutory responsibility to ensure the safe and sound operation of insured nonmember banks and to address the realities of the present market place. Moreover, the FDIC does not feel that indirect securities activities are inherently unsafe or unsound in

all instances. The FDIC does recognize that certain risks may be involved depending upon the securities activities in which a nonmember bank subsidiary is engaged and that certain conflicts of interest can arise from securities activities. The risks and the conflicts of interest can, however, in our opinion, be adequately addressed by proper regulation. FDIC also rejects the argument that the proposal will cause a mass exodus from the Federal Reserve System. Such a forecast is merely speculative and is, in our opinion, unwarranted. Lastly, we have rejected the suggestion that the FDIC merely adopt a policy statement rather than a regulation as the latter is a preferable enforcement tool.

The FDIC also rejects the argument that the agency's position on the Glass-Steagall Act as set out in its policy statement is incorrect. The FDIC is merely applying the clear language of the statute. The only provision of the Glass-Steagall Act that prohibits affiliations between banks and corporations engaged in securities activities applies solely to member banks of the Federal Reserve System. Section 20 of the Glass-Steagall Act specifically provides that no *member* bank shall be affiliated with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution of stocks, bonds, debentures, notes or other securities. Section 32 of the Glass-Steagall Act prohibits persons who are officers, directors, or employees of corporations that are primarily engaged in certain securities activities, or partners or employees of partnerships so engaged, from serving as directors, officers, or employees of *member* banks. Section 21 of the Glass-Steagall Act which does apply to banks whether or not they are members of the Federal Reserve System was found by the Supreme Court to not reach companies related by ownership to banks. In *Board of Governors of the Federal Reserve System* v. *Investment Company Institute*, 450 U.S. 46 (1981) the Court at footnote 24 indicated that "Section 21 prohibits firms engaged in the securities business from also receiving deposits . . . and the language of § 21 cannot be read to include within its prohibition separate organizations related by ownership with a bank, which

does receive deposits." FDIC's literal approach to the Glass-Steagall Act is also fully consistent with two recent Supreme Court cases involving the Glass-Steagall Act, *Securities Industry Association* v. *Board of Governors of the Federal Reserve System*, 104 S.Ct. 2979 (1984) ("Becker") and *Securities Industry Association* v. *Board of Governors of the Federal Reserve System*, 104 S.Ct. 3003 (1984) ("Schwab"). In both instances the Court relied on the plain language of the Glass-Steagall Act in deciding the cases and went so far as to state that it was constrained to abide by the literal meaning of the statute.

The FDIC's action in adopting this regulation is fully within the agency's authority and is consistent with its stated goal of safeguarding the safety and soundness of insured nonmember banks. The courts have recognized that defining what constitutes an unsafe or unsound banking practice in a particular fact situation is within the domain of the banking agencies. The 5th Circuit on two occasions stated that "One of the purposes of the banking acts is clearly to commit the progressive definition and eradication of such practices to the expertise of the appropriate regulatory agencies." *Gross National Bank* v. *Comptroller of the Currency*, 573 F.2d 880, 897 (5th Cir. 1978), *First National Bank of La Margue* v. *Smith*, 610 F.2d 1258, 1265 (5th Cir. 1980). The United States Court of Appeals for the D.C. Circuit has stated with regard to the Comptroller of the Currency's authority under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), one of the statutory provisions from which FDIC derives authority for this rulemaking, that "the Comptroller is entitled to accomplish his regulatory responsibilities over 'unsafe and unsound' practices both by cease and desist proceedings and by rules defining and explicating the practices which in his discretion he finds threatening to a stable and effective national banking system." *Independent Bankers Association of America* v. *Heimann*, 613 F.2d 1164, 1169 (D.C. Cir. 1979). Finally, the FDIC wishes to make clear that it is not, by adopting this final regulation, waiving its right to address on a case-by-case basis practices, conduct, or acts it finds to constitute unsafe and

unsound practices that are not specifically addressed by this regulation. The FDIC will continue to monitor bank direct and indirect involvement in securities activities and will take whatever future action is appropriate.

The provisions of the final regulation and a further summary of the comments received by FDIC are detailed below.

1. Bona Fide Subsidiary

The term "bona fide subsidiary" as proposed for the thirty-day comment period required at a minimum that the subsidiary (i) be adequately capitalized; (ii) be physically separate in its operations from the operation of the bank and not operate on the same floor of a building on which deposits are received; (iii) not share a common name of logo with the bank; (iv) maintain separate accounting and other corporate records; (v) observe separate formalities such as separate board of directors' meetings; (vi) maintain separate employees who are compensated by the subsidiary; (vii) share no common officer with the bank; (viii) have a majority of directors that are neither directors nor officers of the bank; and (ix) conduct business pursuant to policies and procedures independent from the bank so that customers of the subsidiary are aware that the subsidiary is a separate organization from the bank and that investments recommended, offered, or sold by the subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

In proposing the above definition the FDIC indicated that it was not necessarily implying that any association between a bank and its securities subsidiary in the public's mind could harm the reputation of the bank but rather that the FDIC was attempting to ensure the separateness of the subsidiary and the bank. That separation is essential inasmuch as the bank would be prohibited by the Glass-Steagall Act from engaging in many activities the subsidiary might undertake. If a bank's subsidiary is not sufficiently distinct from its parent, the subsidiary may be found to be an alter ego or a mere instrumentality of the bank and the bank

held to be engaging in securities activities in violation of the Glass-Steagall Act. The definition was also designed to ensure the separateness of the subsidiary from the bank as a means of safeguarding the soundness of the parent bank. As stated in the May, 1983 proposal, "the parent bank is less likely to be harmed if the subsidiary has adequate capital and thus can itself absorb losses as well as liabilities arising from the securities operation."

The final regulation adopts a definition of "bona fide subsidiary" that is substantially the same as that which was most recently proposed for comment with a few significant revisions. The final definition retains the requirement that the subsidiary be adequately capitalized. This requirement was generally viewed as proper by those commenting on the May 1983 proposal. No comment was directed to this aspect of the proposed definition during the thirty-day comment period with the exception of the comment of the Investment Company Institute ("ICI") which resubmitted its comment filed in response to the May 1983 proposal. The ICI in commenting unfavorably on the May 1983 proposal opined that the parent bank could not be sufficiently insulated from the subsidiary's financial losses nor the possibility of liability under the securities laws regardless of to what degree the subsidiary is capitalized. After considering this comment, FDIC agreed that a parent bank may be considered a "controlling person" of the securities subsidiary and thus *potentially* subject to liability to the same extent as the subsidiary for any violations of the securities laws on the part of the subsidiary. That liability is not absolute, however. The bank as a "controlling person" may not be liable if it had no knowledge of the circumstances which gave rise to the violation, the bank acted in good faith, and the bank did not directly or indirectly induce the violation. The FDIC therefore concluded that it is possible to structure the relationship between a parent bank and its subsidiary to avoid or lessen the bank's exposure under the securities laws for the acts of the subsidiary.

Although the final regulation requires that the subsidiary be adequately capitalized, it does not define what constitutes adequate capital. No definition had been incorporated in the final regulation as the adequacy of any particular subsidiary's capital can vary from a safety and soundness point of view. It is FDIC's position, however, that the bank's subsidiary must, at a minimum comply with any applicable capital requirements imposed by the Securities and Exchange Commission ("SEC") or imposed under state law. That level of capital is merely a starting point, however, and the FDIC reserves the right to determine that the subsidiary's activities and/or the parent bank's condition warrant that the subsidiary be capitalized over and above any such requirement. It is FDIC's intention to make this assessment during the "notice" period (see section (d) of the final regulation discussed below) and to inform the bank at that time whether in FDIC's opinion the capital position of the subsidiary is adequate. It is FDIC's belief that such a flexible approach will better serve FDIC's supervisory interest in maintaining the safety and soundness of insured nonmember banks.

The final definition also retains the requirement that the subsidiary maintain separate accounting and other corporate records and that the subsidiary observe separate formalities such as separate board of directors' meetings. No adverse comments were received as to either of these two requirements. Also retained is the requirement that the subsidiary maintain separate employees who are compensated by the subsidiary. Bank employees will be permitted, however, to perform so-called "bank office" operations (such as accounting, data processing, and recordkeeping) provided that the bank is fully compensated for such services in an arm's-length transaction. In response to comments that the language of the exclusion for "back-office" operations was ambiguous, the FDIC has reworded footnote 5 of the final regulation which contains that exclusion to permit use of dual employees to perform functions which do not "directly involve customer contact." The proposal had excluded functions which do not "relate to" customer contact.

The separate employee requirements was criticized in a substantial number of comments in response to the May 1983 proposal and in two comments filed during the 30-day comment period. Overall, the comments observed that the requirement would be costly and inefficient, would prevent the bank subsidiary from entering the securities area slowly, would prevent the bank from making available to the subsidiary the expertise of bank personnel already familiar with securities operations, and would probably most adversely impact smaller banks. The FDIC acknowledges that the separate employee requirement can produce some additional costs to insured nonmember banks but anticipates that the exception contained in the final regulation for bank office operations (*i.e.* allowing bank employees to perform administrative, non-customer contact type activities) reduces the inefficiency and added costs that might otherwise be produced. One comment, while recommending that the restriction be liberalized, did agree that the exclusion should alleviate some of the problems cited above. The separate employee requirement has also been retained in the final regulation as it is felt that the use of separate employees in customer contact positions is an extremely important factor in maintaining the separate corporate identity of the subsidiary and the bank. The requirement is also expected to have the added benefit of encouraging banks to hire experienced personnel to operate the subsidiary.

The final regulation retains the basic requirement that the subsidiary's operation be separated from the operation of the bank, however, the language indicating that "physically separate" operation of a subsidiary requires that the securities subsidiary not be located on the same floor of a banking building where deposits are received has been modified. The May 1983 proposal had required that the subsidiary's operation merely be physically separate and had not specified that the subsidiary could not operate on the same floor as the bank. The FDIC's purpose in changing the wording of the definition to that contained in the 30-day proposal was to more clearly demarcate the bank's depository business from the subsidiary's securities business and to prevent

customer confusion regarding the separation. Several comments objected to this restriction as being overly broad and unnecessary, *i.e.* customer confusion can be avoided by less restrictive means and is adequately safeguarded against if the other proposed restrictions contained in the definition of bona fide subsidiary are observed. It was pointed out that as worded, the physically separate requirement would even prohibit a subsidiary of the bank from operating in a separate office with a separate entrance if the office happened to be on the same floor of a building where the bank operates.

The FDIC reevaluated its position and although the agency has determined to retain the requirement that the subsidiary's operation be physically separate and distinct, the minimum separation necessary to meet that regulatory standard has been modified. The revised language would permit the subsidiary's to operate out of an office within a branch of the bank so long as the subsidiary's office is clearly identified and the bank and the subsidiary do not share common entrance. The regulation, however, would permit both to share a common outer lobby or corridor. Existing operations within bank branches will be required to make whatever physical changes are necessary in order for the subsidiary to have separate offices that do not share a common entrance (other than a common outer lobby or corridor) with the bank. In all instances the subsidiary's offices must be clearly identified belonging to the subsidiary.

The FDIC is adopting the physical separation requirement as described above despite the criticism it has received as we find our concern over public misconception as to with what entity the public is dealing to be a paramount concern. We are not comfortable with any less stringent requirement for fear that a bank customer may believe he or she is dealing with the bank or a department of the bank when making securities investments. For example, if the bank's subsidiary underwrites money market funds and an employee of the subsidiary counsels investors at a desk within the branch, there is the unavoidable possibility that

the bank customer may confuse the investment in a money market fund underwritten by the subsidiary as a deposit of the bank even if the customer is given a written disclosure to the contrary. Although proper disclosures can go a long way in avoiding such customer confusion, disclosure *plus* other measures will more effectively separate the identities of the players.

The proposed definition of bona fide subsidiary required that the subsidiary not share a common name or logo with the bank. As previously stated by FDIC, name identification is a factor used by the courts in deciding whether to pierce the corporate veil, is a factor in public identification of the securities operation with the bank, plays a role in the public's misconception as to the insured status of investments placed with the subsidiary, and plays a role in engendering an expectation that the bank is liable for the obligations of the subsidiary. Additionally, a bank may be reluctant to allow a subsidiary to fail if that subsidiary carries the bank's name. The comments on the common name prohibition for the most part have been consistently critical and, in sum, opined that: a business's name is an asset on which it should be permitted to trade, name identification will not necessarily confuse the public, and as nonbanking companies may freely use a common name for any number of enterprises, it is unfair to prohibit banks from doing the same.

Despite this criticism, FDIC has determined to retain the prohibition on the use of a common name or logo by a bank and its securities subsidiary. The final regulation expressly indicates, however, that the restriction does not preclude a bank from advertising and/or otherwise disclosing the relationship between its subsidiary and itself. For example, bank X may advertise the securities services of its full service brokerage subsidiary, Y company, and denote Y company as a subsidiary of bank X. In this way, a bank may still obtain some benefits of name recognition but the public confusion that may arise if the subsidiary uses a common name (especially if that subsidiary operates out of the

bank's branch) is lessened. We continue to feel that this restriction will not unduly competitively harm insured nonmember bank subsidiaries.

Insured nonmember banks should note that if the subsidiary *only* conducts activities that the bank itself could conduct, the need for the subsidiary to not be identified with the bank in order to avoid a Glass-Steagall Act violation is eliminated. The FDIC, however, still intends to require that there be sufficient differentiation between the bank and its subsidiary in its name, advertisements, promotions, customer contacts, etc. so as to avoid any public misconception as to the insured status of any accounts or other investments held by the subsidiary.

The final definition of bona fide subsidiary retains the proposed requirement that the subsidiary not share common officers with the bank and that a majority of its board directors not be directors or officers of the bank. The officer/director requirement has been adopted in order to: (1) Ensure that the subsidiary operates independently from the parent bank, and (2) reduce the likelihood under the "controlling person" doctrine (see above) that the parent bank may be held liable for any securities laws violations on the part of the subsidiary. Five comments addressed the officer interlock restriction, some of which commented in the context of the same restriction found in proposed section 337.4(c) dealing with bank affiliation with securities companies. All five comments criticized the prohibition on any officer of the bank being an officer of the subsidiary (in the case of an affiliate any officer of the affiliate being an officer of the bank). In sum, the comments indicated that the restriction was not necessary in order to achieve a corporate separation under the law, that sharing of officers reduces costs, the restriction will adversely impact smaller banks, and that any conflicts of interest, etc. that might be associated with shared officers are sufficiently addressed under the existing banking laws and regulations.

While one of the comments extended its criticism to the restriction on the composition of the board of directors, several other comments supported that aspect of the restriction. While FDIC

agrees that shared officers and directors will not in and of itself cause the corporate form to be ignored, it is a factor, along with the other criteria set out in the definition of bona fide subsidiary, that a court will consider in deciding whether or not to do so. More importantly, shared officers and directors can play a significant role in determining the liability, if any, under the securities laws of the bank as a "controlling person." This restriction will also help to ensure that the bank subsidiary employs experienced managers. We do not anticipate that the restriction will be unduly burdensome for smaller banks that wish to establish securities subsidiaries as: (1) We expect smaller banks to confine their securities operations to brokerage or underwriting activities that the bank itself could lawfully conduct rather than to enter into underwriting activities the bank could not pursue (in the former instance the subsidiary need not be a bona fide subsidiary), and (2) should a bank establish a securities subsidiary that must be bona fide because of the nature of the activities it pursues, there is no minimum required number of experienced officers it needs to employ to do so. Depending upon the size and nature of the operation, one experienced officer may be sufficient to ensure that the securities operation is well managed.

The final regulation adopts the proposed requirement that the subsidiary conduct business pursuant to independent policies and procedures. The wording has been slightly modified in response to a comment that the phrase "so that customers of the subsidiary are aware that the subsidiary is a separate organization . . ." is ambiguous. The provision as reworded requires the subsidiary to employ "policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization . . . ".

To briefly summarize, FDIC is adopting the definition of bona fide subsidiary substantially as proposed. We recognize that one cannot assure that a court will not pierce the corporate veil between a bank and its subsidiary by establishing a list of requirements and we further recognize that a court would probably not ignore the corporate form on the basis of one or perhaps two of the

criteria the agency has set out. We hope rather to assure through this definition that the bank's subsidiary will be a well managed, fiscally independent, separate corporate body whose operation will not pose a threat to the bank and whose obligations and liabilities as well as the securities products if offers to the public will be perceived by the public to be its own. It is not our intent to establish inordinate burdens nor preclude innovation neither of which consequences do we feel will flow from our action.

The measures that FDIC is requiring to separate the subsidiary from its parent bank are borrowed from corporate law. Similar measures were required by the Federal Home Loan Bank Board when it approved the operation of a savings and loan association service company that would (1) offer securities brokerage and investment advisory services, and (2) operate out of savings and loan association branch offices. The Bank Board's action was challenged in Federal District court and upheld. In response to the charge that the host savings and loan association would be engaging in securities activities in violation of the Glass-Steagall Act, the court refused to pierce the corporate veil between the service corporation and the savings and loan association stating that in view of the prophylactic measures required by the Bank Board, the two organizations must be treated separately. (*Securities Industry Association* v. *Federal Home Loan Bank Board*, 588 F. Supp. 749 (D.D.C., 1984).

2. Underwriting

The regulations as published for 30-day comment restricted a nonmember bank subsidiary's securities underwriting activities that the bank could not lawfully itself conduct to the following: (1) underwriting of investment quality debt securities; (2) underwriting of investment quality equity securities; (3) underwriting of mutual funds whose investments are exclusively limited to investment quality debt securities and/or investment quality equity securities; and (4) underwriting of money market type mutual funds. The term "investment quality debt security" was defined to mean a marketable obligation in the form of a bond,

note, or debenture that is rated in the top four rating categories by a nationally recognized rating service or a marketable obligation in the form of a bond, note, or debenture the investment characteristics of which are equivalent to the investment characteristics of such a top-rated obligation. The term "investment quality equity security" was defined to mean marketable common or preferred corporate stock that is rated medium grade, average or better by a nationally recognized rating service.

Upon a review of the comments, FDIC has determined to revise the definition of investment quality equity security (see discussion in paragraph #3 below) and make the following changes to the underwriting restrictions as set out in proposed § 337.4(b)(1)(i): (1) The reference in § 337.4(b)(1)(i) (as well as elsewhere in the regulation) to mutual funds has been replaced with a reference to investment companies, (2) insured nonmember banks will be permitted to establish or acquire subsidiaries that underwrite investment companies not more than 25% of whose investments consist of investments other than investment quality debt securities and/or investment quality equity securities, and (3) if the subsidiary of an insured nonmember bank meets certain enumerated conditions (*i.e.* is a "qualified underwriter") the subsidiary's underwriting activities will not be limited to those identified in subparagraph (b)(1)(i) (*i.e.* investment quality debt, investment quality equity, money market funds, and qualifying investment companies).

The first revisions to § 337.4(b)(1)(i) is being made in response to a comment which pointed out that by using the term "mutual fund" the regulation excluded from eligibility for underwriting a number of other types of investment companies all of which are subject to regulation under the Investment Company Act of 1940, for example, unit investment trusts which are investment companies that have a defined investment portfolio that does not change. Inasmuch as FDIC did not intend such a result, the final regulation substitutes the term "investment company" for the term "mutual fund".

The second revision to paragraph (b)(1)(i) eliminates the requirement that an investment company invest "exclusively" in investment quality debt or investment quality equity securities in order for the investment company to be eligible for underwriting by the bank's subsidiary. FDIC received several comments which criticized the requirement as overly restrictive. As pointed out by one comment, the restriction would in fact exclude most mutual funds from eligibility as mutual funds are typically diversified within the meaning of the Investment Company Act of 1940; *i.e.* up to 25% of their investments are in securities that would not qualify as investment quality securities under the proposal.

The most significant revision to the proposal allows a "qualified underwriter" to engage in any underwriting activity; *i.e.* there are no product restrictions on the subsidiary if it meets the conditions enumerated in § 337.4(b)(2). Those conditions are: (1) Membership in good standing in the National Association of Securities Dealers ("NASD"), (2) continuous operation for the five year period preceding notice to FDIC as required by this part, (3) no officer, director, general partner, employee, or 10 percent shareholder of any class of voting securities of the subsidiary has been convicted within five years of the notice required by this part of any felony or misdemeanor in connection with the purchase or sale of any security, involving the making of a false filing with the Securities and Exchange Commission, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser, (4) neither the subsidiary nor any of its directors, officers, general partners, employees, or 10 percent shareholders of any class of voting securities of the subsidiary is subject to any state or federal administrative order or court order, judgment, or decree entered within five years of the notice required by this part temporarily or preliminarily enjoining or restraining such person or the subsidiary from engaging in, or continuing, any conduct or practice in connection with the purchase or sale of any security involving the making of a false filing with Securities Exchange Commission, or arising out

of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser, (5) none of the subsidiary's directors, officers, general partners, employees, or 10 percent shareholders are subject to an order entered within five years of the notice required by this part of the Securities and Exchange Commission entered pursuant to section 15(b) or 15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o, 78o-4) or section 203 (c) or (f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(c), (f)), and (6) all officers of the subsidiary who have supervisory responsibility for underwriting activities have at least five years experience in similar activities at NASD member securities firms.

FDIC has determined to adopt the "qualified underwriter" approach after reconsidering comments which urged FDIC to concentrate on the subsidiary's management rather than establishing product restrictions. This approach is also being adopted in light of several comments which brought to our attention that, in attempting to establish an objective standard to measure the investment quality of equity securities by defining "investment quality equity security" as proposed, FDIC excluded from eligibility for underwriting (1) entire industries whose equity securities are not ranked, (*e.g.* auto companies, steel companies, airlines), (2) equity securities of any company that has not been in operation for ten years or more (ranking is typically done by reviewing a stock's performance over a ten-year period in relationship to other stocks), and (3) equity investments other than common or preferred stock such as limited partnerships. Two comments pointed out that: (1) There is no customary or obligatory after market for shares of limited partnerships, (2) neither the subsidiary nor the bank would be identified with any such distribution as only the managing underwriter is named in the prospectus, and (3) there is no capital commitment on the part of the selling broker. (See paragraph #3 below.)

While FDIC recognizes that there are problems with trying to objectively define what constitutes an investment quality equity security and that there are no guarantees that investment grade

equity securities are sound investments, it is still FDIC's feeling that it is appropriate to adopt a guarded stance at the outset with respect to equity underwriting even if utilizing an imperfect standard. FDIC has therefore retained the basic concept of product restrictions where a nonmember bank subsidiary is a de novo entrant into the securities underwriting market. If a nonmember bank acquires a functioning underwriter that is a "qualified underwriter" within the parameters of section 337.4(b)(2), that subsidiary is permitted a wider latitude in its underwriting activities under the final regulation. If the de novo subsidiary meets the remaining conditions for a qualified underwriter after it has been in operation for five years, the subsidiary may, after giving FDIC notice pursuant to § 337.4(d), expand its underwriting activities to ones other than those set out in § 337.4(b)(1)(i). In either case, the FDIC will not be precluded from intervening in, or objecting to, the acquisition of the qualified underwriter, or expansion of underwriting activities into ones permitted to a qualified underwriter, if such intervention or objection is warranted.

While the final regulation permits unlimited underwriting (in the sense of product restrictions) to qualified underwriting subsidiaries of insured nonmember banks, any de novo subsidiary will be limited to underwriting of investment quality debt and equity securities, underwriting investment companies that primarily invest in such securities, and underwriting money market funds. (Investment quality equity securities are normally traded on an exchange thus eliminating pressures on the subsidiary to create an after market. Even if the subsidiary were to create an after market in such securities, there should not be any undue risk due to the right quality of securities.) By adopting this two-tier approach, FDIC hopes to allow nonmember bank subsidiaries the flexibility of slowly moving into larger securities markets as they gain more experience. At the same time, by permitting experienced securities underwriting firms owned by nonmember banks to engage in a larger product market, the FDIC is avoiding what would have been the unintended result of the proposal: precluding underwriting of securities of smaller, regional companies;

companies that have not been operating for ten years or more; and companies whose securities are not ranked because their securities are not felt to be "amenable" to the ranking process. While the parent nonmember banks of such qualified underwriters are arguably exposed to greater risks, the FDIC feels that the requirement that the subsidiary be bona fide and the requirement that the subsidiary be well managed and experienced coupled with the other restrictions of the final regulation sufficiently offset those risks.

Lastly, as was the case with the 30-day proposal, the final regulation does not restrict a nonmember bank's affiliation with a securities company depending upon the activities conducted by that company. As it has indicated in earlier Federal Register Notices, FDIC feels that there is less of a possibility that losses suffered by the bank's parent or sister affiliate due to underwriting activities will adversely impact the bank. This is especially so as the affiliate's ability to move funds out of the bank is limited by several provisions of the final regulation. In any event, the FDIC will have the opportunity when processing change in bank control applications to disapprove a bank's affiliation with a securities company if warranted under that Act.

3. Investment Quality Debt Security/Investment Quality Equity Security

The May 1983 proposal defined the term "investment quality debt security" to mean a marketable obligation in the form of a bond, note, or debenture the investment characteristics of which are not predominantly speculative. The definition specifically included obligations rated in the top four rating categories by a nationally recognized rating service. The definition as revised in the most recent proposal provided that " 'Investment quality debt security' shall mean a marketable obligation in the form of a bond, note, or debenture that is rated in the top four rating categories by a nationally recognized rating service or a marketable obligation in the form of a bond, note, or debenture the

investment characteristics of which are equivalent to the investment characteristics of such a top rated obligation." The revised definition responded to comments on the May 1983 proposal that the phrase "speculative investment characteristics" was overly vague and to comments which indicated that by limiting the definition of investment quality debt securities to rated securities, the FDIC may foreclose access by smaller companies to capital markets.

The definition of investment quality debt security is being adopted as most recently proposed without modification. Only one comment was directed to the definition. It expressed approval of the language as proposed. The definition allows a bank subsidiary to underwrite debt securities that are of comparable quality to highly rated debt securities. As the nonrated debt obligations must still be of high quality in order for the bank's subsidiary to engage in the underwriting, the FDIC does not feel that the broader definition will expose the parent bank to any additional risks.

The most recent proposal defined the term "investment quality equity security" to mean a marketable common or preferred corporate stock that is rated medium grade, average, or better by a nationally recognized rating service. The proposed definition of investment quality equity security did not encompass nonrated equities that have equivalent investment characteristics to top rated equities as, as explained in the supplemental information to the proposal, the science of rating equity securities is not as precise as the science of rating debt securities, nor is it as developed.

In attempting to define what constitutes an investment quality equity security FDIC relied upon ratings of common and preferred corporate stock. According to a comment on the proposed definition, common stock is not rated, but is "ranked" with reference to its standing relative to other common stocks based on a ten-year history of earnings and dividends. The comment further indicated that (1) a significant group of companies in major

industries is not ranked; *e.g.* most auto companies, steel companies, and airlines, and (2) some common stocks are not ranked at all because they are not considered amenable to the ranking process. In short, according to the comment, reliance on rankings of common stock to determine what constitutes an investment quality equity security is misplaced and is too narrow of an approach. Lastly, the comment indicated that, at the very least, FDIC's definition should allow for the underwriting of highly rated preferred corporate stock (preferred stock is "rated" in the same manner and according to much the same standards as bonds are rated) and/or underwriting of unrated preferred stock whose investment characteristics are equivalent to the investment characteristics to top rated preferred stock.

Upon consideration of the above, FDIC has determined to modify the definition of investment quality equity to read as follows: "Investment quality equity security shall mean marketable common stock ranked or graded in the top four categories or equivalent categories by a nationally recognized rating service and marketable preferred corporate stock that is rated in the top four rating categories by a nationally recognized rating service or has investment characteristics that are equivalent to the investment characteristics of such top-rated preferred stock."

Although FDIC acknowledges that using ranking of common stocks as an objective measure of the investment quality of corporate securities is not free from shortcomings, FDIC has determined to retain this limitation on the permissible corporate underwriting activities of subsidiaries of insured nonmember banks for the reasons more fully set forth in paragraph 2 above describing the underwriting provisions of the final regulation.

4. Filing of Notice

The final regulation adopts the notice provision as proposed with minor changes. Under the final regulation the bank must give the appropriate FDIC regional office written notice of intent to establish or acquire a subsidiary that engages in any securities activity at least 60 days prior to consummation of the acquisition

or commencement of the operation of the subsidiary, whichever is earlier. The regulation also requires that, in addition to the 60-day advance notice, a bank must file a written follow-up notice with the appropriate FDIC regional office within 20 days after the acquisition is consummated or the subsidiary commences operations, whichever is earlier. The regulation does not specify the content of the written notice of intent. By not specifying the content of the notice, the FDIC is permitting a bank to satisfy the notice requirement in any way it finds most convenient. For example, if the subsidiary will be registered with the SEC, a copy of the SEC filing may simply be forwarded to the appropriate FDIC regional office.

Where the 60-day advance notice pertains solely to an instance where a bank transfers to its subsidiary securities activities previously performed by the bank, the bank is required under the final regulation to file an additional notice with the regional office if the subsidiary expands into restricted activities; *i.e.*, the underwriting activities referenced in subparagraph (b)(1)(i) and paragraph (b)(2) of the final regulation. Likewise, if the subsidiary gives the FDIC 60 days advance notice regarding the establishment or acquisition of a subsidiary that will engage in subparagraph (b)(1)(i) activities, an additional notice must be given to the regional office if the subsidiary commences broadened underwriting activities as permitted by paragraph (b)(2).

These notices serve as a supervisory mechanism that will apprise FDIC of which insured nonmember banks are conducting securities activities through their subsidiaries that pose potential risks to which the bank would not otherwise be exposed. The subsequent notice is a one-time notice, *i.e.*, the first time the subsidiary commences any activity covered by paragraph (b)(1)(i) or (b)(2), notice must be filed. No subsequent notice is required if the subsidiary later begins another underwriting activity covered by (b)(1)(i) or (b)(2) that was not the activity which triggered the above notice. The only comment received by FDIC during the most recent comment period which addressed the notice requirements objected to a bank having to give FDIC

notice if it transfers securities activities from the bank to a subsidiary. The requirement is being retained, however, as FDIC does not feel that the requirement is burdensome and moreover because the information will aid FDIC in discharging its supervisory responsibilities.

It is the FDIC's intent to use the notices required by the final regulation as a point of reference. The regional office will contact the bank seeking further information if the bank's condition or other facts warrant a closer review. It is for this reason that the regulation requires that the initial notice be received at least 60 days in advance. The 60-day notice can be waived at the FDIC's discretion where such period is impractical, *e.g.*, where the acquisition is the result of a purchase and assumption transaction or an emergency merger. The subsequent notice must be received in the regional office within 30 days after the subsidiary commences the triggering underwriting activity. Prior notice is not required in this instance as it was felt to do so would be too impractical and would unduly interfere in the day-to-day operations of the subsidiary. None of the notice requirements are an approval process although the FDIC will not be precluded from intervening in an intended acquisition or establishment of a subsidiary or from objecting to the expansion of activities if such intervention or objection is warranted, for example, if the subsidiary would not appear to meet the requirements for a bona fide subsidiary, or any details of the planned transaction (such as the source of funding for the establishment or acquisition of the subsidiary) present any supervisory concerns.

The final regulation does not require a written notice when a bank becomes affiliated with a securities company. For the most part, affiliation with a securities company will arise out of a change in bank control or come to FDIC's attention when a bank seeks deposit insurance. As the FDIC will become aware of the affiliation prior to consummation in both instances, there is no need to create an additional notice requirement.

5. Lending Restrictions

The most recent proposal contained a number of restrictions designed to prevent abuse of a bank's credit facilities. Such abuse can arise in several ways, for example, the making of imprudent loans to companies whose securities are underwritten or distributed by the bank's subsidiary or affiliate in an effort to improve the condition of the company and thus the marketability of the company's securities. The proposal would have prohibited a bank from: (1) Making extensions of credit to any company whose securities are currently underwritten or distributed by the bank's affiliate unless those securities qualify as investment quality debt securities or investment quality equity securities, (2) making any extension of credit to a money market fund or mutual fund currently underwritten or distributed by the bank's subsidiary or affiliate, (3) making any extension of credit where the proceeds are to be used to acquire securities currently issued, underwritten or distributed by the bank's subsidiary or affiliate or currently issued by an investment company advised by the bank's subsidiary or affiliate, (4) making any extension of credit to its securities subsidiary or affiliate that does not comport with section 23A of the Federal Reserve Act, (5) making any extension of credit to any investment company advised by the bank's subsidiary or affiliate if the extension of credit does not comport with section 23A of the Federal Reserve Act, (6) directly or indirectly conditioning any extension of credit to a company on the requirement that the company contract or agree to contract with the bank's subsidiary or affiliate to underwrite or distribute the company's securities, and (7) directly or indirectly conditioning any extension of credit to any person on the requirement that that person purchase any security currently underwritten or distributed by the bank's subsidiary or affiliate. (Items 6 and 7 are discussed in paragraph #9 below.)

The lending restrictions are being adopted as most recently proposed two minor changes: (1) The reference to "money market fund" and "mutual fund" contained in paragraph (e)(4) has been replaced with the term "investment company", and (2) the

restriction on extensions of credit to companies whose non-investment quality securities are currently underwritten or distributed by the bank's affiliate has been expanded to cover companies whose non-investment quality securities are currently underwritten or distributed by the bank's subsidiary. The expanded coverage is necessary as qualified underwriting subsidiaries of nonmember banks may underwrite securities that are not investment quality. The lending restrictions and the basis for their adoption are discussed separately below.

Paragraph (e)(3) of the final regulation prohibits a bank from extending credit to any company the stocks, bonds, debentures, notes or other securities of which are currently underwritten or distributed by a subsidiary or affiliate of the bank unless those securities qualify as investment quality debt securities or investment quality equity securities. Paragraph (e)(3) is designed to address the concern that a bank may make imprudent loans to companies whose lower quality securities are underwritten or distributed by the bank's subsidiary or affiliate in an effort to improve the condition of the company and thus the marketability of its securities. Inasmuch as the securities in question must be investment quality in order for the company to be eligible for extensions of credit from the bank, the above concern is eliminated. If the bank's subsidiary is engaging in underwriting activities as permitted by section 337.4(b)(2), the bank would not be able to extend credit to any company whose securities the bank's subsidiary currently underwrites or distributes assuming of course that the securities in question are not investment quality.

In determining whether an underwriting or distribution is "current", the bank may rely upon the affiliate's or subsidiary's statement that any particular underwriting or distribution has terminated. A footnote to paragraph (e)(3) indicates that the restrictions of (e)(3) are not to be construed as prohibiting the bank from honoring a loan commitment or revolving loan agreement of funding a line of credit where such loan commitment, revolving loan agreement, or line of credit was entered into prior in time to the underwriting or distribution. It is felt that this

exclusion coupled with the definition of investment quality debt security and investment quality equity security (both of which take into consideration unrated debt and unrated preferred corporate stock that has investment characteristics equivalent to those of highly rated securities) prevents the restrictions of paragraph (e)(3) from having an adverse effect on the availability of credit. The same footnote also provides that the restrictions of (e)(3) do not apply to extensions of credit to non-U.S. companies whose securities are underwritten or distributed outside the United States by an insured nonmember bank's non-U.S. affiliate. This exclusion has been added in response to comments from several foreign banks. (See paragraph #14 below.)

Paragraph (e)(4) of the final regulation prohibits a bank from making any extension of credit or loan directly or indirectly to any investment company whose shares are currently underwritten or distributed by a subsidiary or affiliate of the bank. As stated in the preamble to the proposal, FDIC considered exempting mutual funds and money market funds from the reach of the lending restriction. Such an exemption was rejected, however, inasmuch as the credit needs of such funds are most likely to arise when the fund is having liquidity problems. If interest rates should rise sharply and large numbers of shareholders, especially institutional investors, redeem their shares to put their money directly into higher paying investments, a fund could face a liquidity crisis. A bank may thus be tempted to make an unsound loan to the fund in order to prevent the fund from suffering a loss by selling portfolio assets at a depressed price to meet liquidity needs. As the FDIC received no comments critical of the restriction, and it is still our opinion that the restriction is warranted, the final regulation retains the provision as proposed with the exception of the reference change to "investment company". Money market funds have been targeted within the prohibition despite their relative stability as at present there is no self-regulatory organization such as the NASD to watch-dog money market funds.

Paragraph (e)(5) of the final regulation prohibits a bank from extending credit for the purpose of acquiring securities currently underwritten or distributed by the bank's subsidiary or affiliate, securities issued by an investment company advised by a bank's subsidiary or affiliate, or securities issued by the bank's subsidiary or affiliate. The provision contains an exception that would permit the bank to extend credit to any employee of the subsidiary or affiliate where the purpose of the loan is to acquire securities of the subsidiary or affiliate through an employee stock bonus or stock purchase plan adopted by the board of directors or board of trustees of the subsidiary or affiliate. Footnote 11 indicates that the bank in complying with paragraph (e)(5) may rely in good faith on the customer's statement as to the purpose of the loan. FDIC received one comment addressing the above described purpose lending restriction. That comment urged FDIC to merely require that any purpose loan by the bank comply with safe and sound banking practice rather than prohibiting purpose loans in their entirety. FDIC still feels, however, that this prudential restriction is warranted especially in a supervisory environment which is progressively moving toward fewer on-site examinations at greater intervals.

Paragraph (e)(6) of the final regulation subjects extensions of credit by a bank to the bank's subsidiary to the same loan ceiling and other restrictions as would be applicable under section 23A of the Federal Reserve Act if that subsidiary were an affiliate for the purposes of that statute. Paragraph (e)(6) also places extensions of credit to the bank's affiliate under the same restrictions. Paragraph (e)(7) subjects extensions of credit by a bank to an investment company advised by the bank's subsidiary to the same loan ceiling and other restrictions that would be applicable under section 23A of the Federal Reserve Act if that subsidiary were an affiliate within the meaning of section 23A and makes extensions of credit to investment companies advised by the bank's affiliate's subject to the same restrictions. As loans or extensions of credit to the bank's affiliate as that term is defined in the regulation are already covered by the language of section 23A, placing

affiliates under the restrictions of paragraph (e)(6) does not establish any additional requirements. Additionally, as section 23A covers extensions of credit to investment companies advised by the bank's affiliates, placing affiliates under the restriction of paragraph (e)(7) does not establish any additional requirements. The final regulation expressly incorporates the exemptions contained in section 23A as well as the restrictions. These provisions did not receive any adverse comment during the 30-day comment period and thus are being adopted as proposed. (FDIC did receive one comment opining that Congress did not intend for subsidiaries of banks that advise mutual funds to be subject to section 23A. Although that may or may not be the case, FDIC has determined that certain risks may be present even when the subsidiary merely acts as an adviser to an investment company and that those risks are appropriately addressed by section 23A-type restrictions.)

6. Trust Department Restrictions

One safety and soundness problem associated with securities activities of subsidiaries and affiliates of nonmember banks is dumping of poor securities into the bank's trust department. The May 1983 proposal contained a provision designed to address that concern that would have prohibited an insured nonmember bank which has a subsidiary or affiliate that engages in the sale, distribution or underwriting of stocks, bonds, debentures, notes or other securities or acts as an investment adviser to any investment company that sells, distributes, or underwrites any such security, from purchasing in its sole discretion as fiduciary or co-fiduciary any security currently being issued, distributed, or underwritten by that subsidiary or affiliate or purchasing in its sole discretion any security currently being distributed, underwritten, or issued by an investment company advised by the subsidiary or affiliate. The May 1983 proposal also would have prohibited an insured nonmember bank from transacting business through its trust department with its securities subsidiary or affiliate unless the transactions are comparable to transactions with an unaffiliated

securities company or a securities company that is not a subsidiary of the bank. The later provision was designed to insulate the bank from the possibility that its securities subsidiary or affiliate will drain off profits from the bank.

In response to comments that the phrase "in its sole discretion" should be clarified, paragraph (e)(1) of the proposed regulation was reworded to permit insured nonmember banks to purchase, as fiduciary or co-fiduciary, securities currently distributed, underwritten or issued by the bank's subsidiary or affiliate or currently issued by an investment company advised by the bank's subsidiary or affiliate where those purchases are expressly authorized by the trust instrument, court order, or local law, or specific authority for the purchase is obtained from all interested parties after full disclosure. As FDIC indicated in its earlier publications, the provision merely restated the common law obligation of a fiduciary to refrain from self dealing and was at the same time consistent with the following statement regarding trust department examinations found in FDIC's Manual of Examination Policies: "It is a general axiom that a bank has a definite moral responsibility, as well as legal, not to deal with itself in the administration of a fiduciary account."

FDIC's examination manual also goes on to state that a bank should not invest fiduciary funds in its own obligations or stock unless court order, local law or the trust instrument authorizes the purchase and retention of the obligation or stock, or specific authority for the investment is obtained from all interested parties.

FDIC received several comments addressed to paragraph (e)(1) of the proposal all of which objected to the provision as worded. The comments indicated that the "expressly authorized" requirement was too strict; the requirement might neccessitate redrafting existing trust instruments which in some cases could prove impossible; obtaining specific authority from all interested parties could be costly and perhaps impossible; and the provision may preempt existing law or at best cause confusion. In response to these comments, paragraph (e)(1) has been

revised in the final regulation so as to provide that the bank is prohibited from purchasing in its discretion as fiduciary, co-fiduciary, or managing agent any security currently underwritten, distributed, or issued by the bank's subsidiary or affiliate or any security issued by an investment company advised by the bank's subsidiary or affiliate unless one of three conditions are met: (1) The purchase is expressly authorized by the managing agency agreement, trust instrument, court order, or local law, or specific authority for the purchase is obtained from all interested parties after full disclosure, (2) the purchase, although not expressly authorized under item 1, is otherwise consistent with the bank's fiduciary obligation, or (3) the purchase is permissible under any applicable federal and/or state statute or regulation. Condition three is designed to take into account, for example, federal law governing employee benefit and pension plans which would permit, in certain instances, transactions involving such funds and affiliates of the funds' trustees. Condition two is responsive to the comment that in order to meet its fiduciary obligation, a trustee is not always required to obtain the authorizations covered by item one.

FDIC feels that paragraph (e)(1) as adopted in final should provide sufficient flexibility so as to not conflict with existing fiduciary common law and/or federal or state statutes or regulations governing the operation of trust departments and the duty of fiduciaries. At the same time it should prevent abuses that might otherwise arise. It should be noted that (e)(1) as adopted also covers purchases by the bank in its discretion as managing agent. Paragraph (e)(1) thus covers a situation where the bank is the managing agent for an investment account and the bank has investment discretion over that account. Although the bank is not a fiduciary with respect to that agency account in the same sense as if it were a trustee of a trust account, the bank still has certain obligations with respect to the account and it is in a position through its investment discretion to take securities off the

hands of its subsidiary or affiliate. FDIC has therefore concluded that (e)(1) is appropriately expanded to cover such instances.

The final regulation adopts paragraph (e)(2) as proposed. Under that provision the bank is prohibited from transacting business through its trust department with the bank's subsidiary or affiliate unless the transactions are at least comparable to transactions with an unaffiliated securities company or a securities company that is not a subsidiary of the bank. The purpose of (e)(2) is to ensure that when a bank's subsidiary or affiliate executes securities transactions on behalf of the bank's trust accounts, the costs associated with those executions (both to the bank and the trust account) are not inflated, *i.e.* not substantially greater than would have been incurred if dealing with an unaffiliated securities company. To the extent those costs are inflated, the bank, may suffer, *i.e.* the subsidiary or affiliate may drain off profits from the bank, or trust customers may suffer, *i.e.* the higher costs are passed on to the customer.

FDIC received one comment urging that paragraph (e)(2) be amended to require that such transactions be at cost as a beneficiary of a trust is entitled to a trustee which is free from the incentive to generate transactions in order to produce commission income. FDIC has not adopted an "at cost" requirement as the requirement of paragraph (e)(1) should adequately ensure against churning and other acts that can constitute a breach of fiduciary obligation on the part of the trustee when the bank is dealing with its subsidiary or affiliate. It should be noted that (e)(2) does not prohibit a bank's trust department from using the broker/dealer services of its subsidiary or affiliate to execute transactions on behalf of fiduciary accounts. The bank's decision to utilize the subsidiary's or affiliate's services (and the transaction as a whole) must fully comport, however, with the bank's fiduciary obligation to its trust department customers. It is not FDIC's intent to countenance any transaction or practice which, although "comparable" to transactions with unaffiliated securities companies, is otherwise a breach of fiduciary obligation.

7. Investment Ceiling

Paragraph (b)(3) of the proposed regulation would have restricted an insured nonmember bank's direct and indirect investment in one or more securities subsidiaries to 20% of the bank's primary capital unless the FDIC approves a greater investment. Although few of the comments received over the course of the rulemaking criticized the proposed investment restriction, the FDIC has determined to eliminate that portion of the regulation. The final regulation retains, however, the statement that the bank's investment in its securities subsidiary will not count toward the bank's capital. The investment limitation is being eliminated as the FDIC, upon further reflection, concluded that the investment ceiling was unnecessary inasmuch as the bank's investment in the subsidiary will be excluded from the bank's capital.

The exclusion provides the FDIC with a strong enforcement tool to help safeguard the bank's safety and soundness. If, for example, the FDIC should determine after receiving notice that an insured nonmember bank's capital would not be adequate after making the necessary adjustments, the bank could be subject to enforcement action if it were to proceed with the acquisition or establishment of the subsidiary. The automatic exclusion of the investment from the bank's capital will provide the FDIC greater assurance that the bank and subsidiary are independent, financially viable entities and will prevent institutions with marginal capital from taking on additional activities that could pose additional risks.

8. Affiliation With a Securities Company

Section 337.4(c) of the proposed regulation would have prohibited an insured nonmember bank from becoming affiliated with a securities company unless: (1) The securities business of the affiliate is physically separate in its operation from the operation of the bank and does not operate on the same floor of a building on which the bank receives deposits; (2) the bank does not share common officers with the affiliate; (3) a majority of the

board of directors of the bank is composed of persons who are neither directors nor officers of the affiliate; (4) any employee of the affiliate who is also an employee of the bank does not conduct any securities activities on behalf of the affiliate on the premises of the bank that involve customer contact; (5) the bank and affiliate do not share a common name or logo; and (6) the affiliate conducts business pursuant to policies and procedures independent from the bank so that customers of the affiliate are aware that the affiliate is a separate organization from the bank and that investments recommended, offered or sold by the affiliate are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

The May 1983 proposal only required that the securities business of the bank's affiliate be "kept separate and distinct from the banking business of the insured nonmember bank". Inasmuch as the FDIC did not necessarily mean to imply that the affiliate could more closely mingle its operations with the bank than could the bank mingle operations with its subsidiary, the FDIC specifically proposed restrictions that paralleled those set forth for subsidiaries of insured nonmember banks. In doing so, the FDIC indicated that it felt that the restrictions were as warranted in the case of an affiliate as in the case of a subsidiary. The proposal further indicated that it was felt that the restrictions were necessary in order to avoid customer confusion, to avoid conflicts of interest, to avoid a finding that the bank is itself engaged in prohibited securities activities, and to avoid a finding that the affiliated securities company is taking deposits in violation of section 21 of the Glass-Steagall Act. For example, if the FDIC approves deposit insurance for a newly chartered bank whose parent is a securities company and the bank is so closely intertwined with its parent that one could find the parent securities company is taking deposits, the FDIC would, by its action, countenance a violation of the Glass-Steagall Act.

The FDIC specifically sought comment on the necessity of the above restrictions and the problems, ramifications, burdens, etc.,

if any, that might be associated with the director/officer restriction and the prohibition on the use of common names or logos. With the exception of the comments to be discussed below, the comments FDIC received which addressed the proposed restriction on bank affiliations with securities companies have essentially been outline in paragraph #1 above which discusses the definition of bona fide subsidiary. (Inasmuch as the restrictions in proposed section 337.4(c) essentially parallel the restrictions for bona fide subsidiaries, comments directed to one provision, for the most part, raised issues equally applicable to the other.)

One comment made on behalf of several securities companies which are presently affiliated with insured nonmember banks or which intend to affiliate therewith made the argument that FDIC has not adequately supported its case for restricting the affiliation of a nonmember bank with a securities company *i.e.*, even if there is a basis to define bona fide subsidiary as proposed, there is a fundamental difference between a bank being owned or otherwise affiliated with a securities company and a bank establishing or acquiring a securities subsidiary. This comment, as well as others, primarily focused on the prohibition on the use of a common name or logo, the restriction on shared officers, and the restriction on the composition of the bank's board of directors. One comment suggested exempting banks that are presently affiliated with securities companies from the common name prohibition (either by a premanent grandfather or through a list of exemptive criteria such as the amount of the affiliate's revenue, capital, or assets, the length of time the affiliate has been in business, and the location of a majority of the affiliate's offices). Such banks, said the comment, have expended considerable amounts of money in promotional activities (albeit less than that which would have been expended if they could not have relied on the name identification of their parent) and would need to expend far more to recapture the market position they presently hold if they are required to change their names.

Additionally, several comments objected to the proposed requirement that the affiliate conduct business pursuant to independent policies and procedures. One such comment felt that the requirement constituted an unwarranted intrusion on the affiliate's operations and was beyond FDIC's authority. Several others pointed out that under the language as proposed, an affiliate of a nonmember bank could not broker the bank's deposits as the provision requires the affiliate to make its customers aware that investments recommended or sold by the affiliate are not bank deposits, are not insured by the FDIC, nor are obligations of the bank. Lastly, several comments pointed out that § 337.4(c) would require that the affiliated securities company comply with the restrictions contained therein regardless of whether the securities company was solely conducting activities of the sort permitted to the bank under the Glass-Steagall Act. A subsidiary of a bank on the other hand only need meet the criteria for a bona fide subsidiary if it conducts securities activities which the bank could not conduct. After carefully weighing these comments, FDIC has determined to go forward with proposed § 337.4(c) with certain modifications described below.

The final regulation restricts under section 337.4(c) the affiliation of a securities company and a nonmember bank where the affiliate directly engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes or other securities. The language change thus tracks the language of section 21 of the Glass-Steagall Act and in effect cuts back the scope of the provision from that which was proposed. Under the new language, to the extent that the affiliate engages in any other securities activities (*i.e.* ones not encompassed by section 21 of the Glass-Steagall Act) the affiliate is not subject to § 337.4(c). As in the case of a nonmember bank subsidiary, however, it is still FDIC's intent to require that there be sufficient differentiation between the bank and its affiliate in the bank's name, advertisements, promotions, etc. so as to avoid any public misconception as to with whom it is dealing. Also, under the provision as revised in the final regulation, only a securities company that *directly* engages in the sale,

distribution, or underwriting of securities is subject to the restrictions of § 337.4(c). (The proposal would have covered companies directly or indirectly engaged in securities activities.) For example, a nonmember bank may share officers with its parent holding company that does not itself engage in securities activities except where those persons are also officers of a company controlled by the bank's parent (*i.e.*, an affiliate of the bank as defined in § 337.4(a)(1)) that underwrites securities).

A securities company subject to § 337.4(c) will not be required to be physically separate in its operations from the operations of its affiliated nonmember bank in the sense of not operating on the same floor of a building on which the bank receives deposits. As is the case with a subsidiary, however, the final regulation retains the requirement that the affiliate be physically separate and distinct in its operations from the operation of the bank. The final regulation thus would allow the affiliated securities company to have a separate office located in the branch so long as it was clearly demarcated as belonging to the affiliate and conversely would allow the bank to be housed in the same building, on the same floor as the affiliate so long as separate, clearly demarcated offices are maintained. In both instances, access to the affiliate's offices may not be through a common entrance with the exception that a common outer lobby or corridor is permitted.

The final regulation requires that the affiliate conduct business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate that the affiliate is a separate organization from the bank and that investments recommended, offered or sold by the affiliate are not bank deposits, are not insured by the FDIC, nor are otherwise obligations of, nor guaranteed by, the bank. A footnote has been added to the provision to clarify that this restriction is not to be construed to prohibit the affiliate from engaging in the brokering of deposits to the extent otherwise permitted by law and/or regulation. Lastly, the final regulation retains the prohibition on the use of a common name or logo. Section 337.4(c) has been

amended, however, to indicate that this prohibition does not preclude the bank from disclosing in its promotions, advertisements, etc. that it is affiliated with a securities company. The remaining portions of § 337.4(c) are being adopted as proposed. The FDIC rejected the idea of grandfathering banks presently sharing a common name or logo with securities affiliated because of the continued possibility of public confusion. Likewise, an asset or revenue based exemption is, in the FDIC's opinion, inappropriate as public confusion may still result. Additionally, a numerical or ratio test would be unmanageable over time and potentially more disruptive for banks affiliated with securities companies.

The FDIC is taking the above described action in an attempt to address three concerns: (1) Safety and soundness (FDIC wants to ensure that the bank is independent and operated in a manner consistent with safe and sound banking practice); (2) protection of the insurance fund (FDIC wants to avoid claims against the bank arising out of the public's misconception as to with whom it is dealing); and (3) compliance with section 21 of the Glass-Steagall Act which prohibits companies engaged in the business of issuing, selling, distributing, or underwriting securities from taking deposits (if the bank is a "captive" institution, the affiliate may be found to be taking deposits). The FDIC feels that the elements contained in § 337.4(c) of the final regulation all play an important part in achieving those ends. Taken as a whole, we do not feel that the restrictions are overly burdensome nor that they will interfere with the internal operations of the affiliate. Nor do we feel that the prohibition on common names or logos (the restriction which received the most criticism) will put nonmember banks affiliated with securities companies at an undue disadvantage or deprive them of the goodwill of their affiliate's name. Nonmember bank's presently affiliated with securities companies that share a common name or logo with their affiliate may still obtain some of the benefits of name recognition by identifying themselves as being affiliated with the securities company. Such banks also have some flexibility in coming into compliance with the bank on common name or logo as they are

required to conform to § 337.4(c) as soon as practicable, but not to exceed one year without the FDIC's consent.

9. Tying

The final regulation adopts without revision the anti-tying prohibition that was proposed for comment. Paragraph (e)(8) of the final regulation prohibits an insured nonmember bank from either directly or indirectly conditioning an extension of credit to any company on the requirement that the company contract, or agree to contract, with the bank's subsidiary or affiliate to underwrite or distribute that company's securities. Paragraph (e)(8) also prohibits a bank from conditioning an extension of credit to any person on the requirement that that person purchase any security currently underwritten or distributed by the bank's subsidiary or affiliate. Although insured nonmember banks that are part of a bank holding company system are subject to similar anti-tying restrictions under the Bank Holding Company Act Amendments of 1970, that Act would not seem to cover banks that are not held by bank holding companies in that the restrictions cover the tying of a loan with some additional credit, property, or service from the bank, the bank's holding company, or any other subsidiary of the bank's holding company. (12 U.S.C. 1972). The restriction in the final regulation fills that gap and serves as a reminder to all insured nonmember banks not to engage in unlawful tying practices. As a large number of insured nonmember banks are held by bank holding companies, the imposition of this requirement would not represent a major change from the status quo.

10. Construction of the Terms "Underwrite", "Distribute", and "Security"

It is not FDIC's intent by adopting this regulation to prevent an insured nonmember bank subsidiary from engaging in any securities underwriting activity that the insured nonmember bank may

itself lawfully pursue under the Glass-Steagall Act. Those activities are set forth in 12 U.S.C. 24 (Seventh) and include underwriting obligations of the United States, general obligations of any state political subdivision thereof, and numerous other obligations specifically named therein. Insured nonmember banks should keep in mind that the terms "underwrite" and "distribute", and the phrase "stock, bonds, debentures, notes, or other securities" are to be construed consistently with the securities laws and regulations except where the context requires otherwise. A securities subsidiary or affiliate of an insured nonmember bank while engaged in the conduct of securities activities will be subject to the securities laws and regulations, the oversight of the SEC, and oversight by entities such as the NASD. The above terms are therefore to be construed consistently with the securities laws and regulations when used in connection with the subsidiary or affiliate. Reference in the final regulation to these terms as used in conjunction with an insured nonmember bank (see paragraphs (b)(1)(i), (f) and (g)) are to be construed consistently with the Glass-Steagall Act.

11. Definition of "Affiliate", "Subsidiary", and "Extension of Credit"

The final regulation defines the term "affiliate" to mean a company that directly or indirectly controls an insured nonmember bank and any company under common control with an insured nonmember bank. The term "affiliate" as defined herein differs from the proposed definition which included as an affiliate "any company controlled by a company, person, or group of persons that controls an insured nonmember bank." The phrase "any company under common control with an insured nommember bank" has been substituted in the final regulation in order to clarify the scope of the definition. "Control" is defined as the power to directly or indirectly vote 25 percent of a bank's or company's stock, the ability to control the election of a majority of a bank's or company's directors or trustees, or the ability to exercise a controlling influence over the management and policies

of a bank or company. At a minimum, the final regulation treats as affiliates of the bank a bank's parent company, a company that controls 25% or more of the bank's stock, and companies controlled by either of the above.

The term "subsidiary" is defined in the final regulation to mean a company controlled by a bank. As "company" is defined in the final regulation to include corporations other than banks, partnerships, business trusts, associations, joint ventures, pool syndicates or other similar business organizations, a securities company operated by several banks in a cooperative effort can be considered a subsidiary of each of the banks. Although it is possible for a mutual fund (i.e., a business trust) to be a subsidiary of the bank if controlled by the bank, we anticipate that this will not generally be the case. All of the above terms are being adopted in the final regulation as most recently proposed as none of the definitions received comment.

The term "extension of credit" as defined in the final regulation has generally the same meaning as found in Federal Reserve Board Regulation O (12 FR 215.3) which concerns insider transactions. The term as defined herein covers, however, purchases, "whether or not under repurchase agreement" of securities, other assets, or obligations. The "whether or not" language is included in the final regulation in an attempt to control the extent to which a bank may indirectly pour money into the subsidiary by means of purchasing securities and other assets from the subsidiary. The term also differs from that used in Regulation O in that a "draw" upon a line of credit is an extension of credit whereas a "grant" of a line of credit is not.

Although the term extension of credit is defined to include a purchase of securities, it is not FDIC's intent to prohibit a bank from purchasing, at a customer's direction, securities underwritten or distributed by the bank's subsidiary or affiliate. FDIC received a comment which inquired whether or not such a purchase would be permittted under pargraphs (e)(3) and (e)(4) of the regulation inasmuch as those provisions prohibit extensions of credit (said term including purchases of securities)

to investment companies whose securities are underwritten or distributed by a bank's subsidiary or affiliate and extensions of credit to companies whose lower quality securities are underwritten or distributed. The answer is no. Likewise, a bank is not prohibited under paragraph (e)(7) from purchasing at the direction of a bank customer shares of an investment company advised by a subsidiary or affiliate of the bank, *i.e.* the purchase may be made without regard to the limitations and restrictions of section 23A of the Federal Reserve Act. Any purchases, however, by the bank for its own account of securities issued, distributed, or underwritten by the bank's subsidiary or affiliate or an investment company advised by the bank's subsidiary or affiliate is encompassed within the scope of the term extension of credit.

12. "Phase-Out"Provision

The final regulation requires all insured nonmember banks that established or acquired securities subsidiaries prior to the effective date of the regulation or which became affiliated with securities companies prior to the effective date of the regulation to bring themselves into compliance with the regulation within two years. Any bank that established or acquired a securities subsidiary prior to the relevenat date must, however, comply with §§ 337.4(b)(1)(ii), 337.4(c) and 337.4(e) as soon as practicable such time not to exceed, however, one year unless the FDIC consents. Section 337.4(b)(1)(ii) requires that the subsidiary be a bona fide subsidiary if it conducts activities not permitted to the bank under the Glass-Steagall Act. Section 337.4(c) pertains to affiliations with securities companies and § 337.4(e) places lending and other restrictions on the bank. The final regulation also requires that any insured nonmember bank that is subject to the phase-out provision must inform the FDIC in writing within thirty days from the effective date of the regulation that it has a subsidiary or affiliate that conducts securities activities. This notice will provide FDIC with a mechanism to monitor compliance with the phase-out requirement.

The phase-out provision as adopted differs from the proposal in one respect. The final regulation more clearly denotes what the FDIC feels is a reasonable time period for a nonmember bank to comply with certain provisions of the regulation. The final regulation is still flexible on compliance as to those provisions, however, as the bank may request a longer time period to come into compliance.

The FDIC specifically requested comment addressing two issues with respect to the phase-out provision: (1) Is immediate compliance more appropriate than a phase-out provision in view of FDIC's stance that the restricted activities may pose a safety or soundness problem, and (2) if a phase-out provision is adopted, should it be longer than two years or shorter. FDIC did not receive any comments addressing either point. We did receive a comment urging FDIC to make the regulation prospective only, *i.e.* exempt banks that became affiliated with securities companies prior to the effective date of the regulation from the requirements of § 337.4(c). FDIC does not feel that an exemption is warranted in view of the agency's concerns as outlined in paragraph #8 above. Furthermore, FDIC does not feel that compliance with the regulation by such banks will be onerous inasmuch as the affected banks are given one year to comply with the regulation. To the extent that such banks have supplies of stationery and other printed matter on hand which carry the same name as the bank's securities affiliate (something in contravention of § 337.4(c)(v)), the banks will not be precluded from using the existing supplies. FDIC will expect the bank to take reasonable steps toward compliance as soon as possible and to ultimately comply within one year unless the FDIC otherwise consents.

Lastly, any insured nonmember bank that is presently subject to an outstanding order imposing conditions that are inconsistent with the final regulation, or that has agreed to conditions that are inconsistent with the final regulation, is still subject thereto and must file a request with FDIC's Board of Directors that the inconsistent conditions be listed.

13. Sections 337.4(f) and 337.4(g)

These sections of the final regulation are being adopted without change. They serve to remind insured nonmember banks that (1) it is not FDIC's intent to prohibit a bank subsidiary from conducting any securities activity that the bank itself could lawfully conduct under the Glass-Steagall Act, and (2) that the regulation does not authorize the bank to itself conduct any securities activities that are not lawful under the Glass-Steagall Act. We wish to stress that the final regulation does *not* authorize any insured nonmember bank to either directly, or indirectly through a subsidiary, conduct any securities activity. An insured nonmember bank must derive that authority, if at all, from some other source, such as state law.

14. Foreign Banks and Insured Branches of Foreign Banks

FDIC received during the most recent public comment period several comments urging FDIC to exempt insured branches of foreign banks from the restrictions of the regulation. One comment urged that FDIC exempt domestic U.S. bank subsidiaries of foreign banks as well. The comments indicated that, as proposed, the regulation could have an extraterritorial effect, *i.e.* it could prohibit U.S. branches or commercial bank subsidiaries of foreign banks from making loans to non-U.S. companies whose securities are underwritten or distributed outside the United States by non-U.S. subsidiaries or affiliates of the parent foreign bank. The comments also indicated that application of the proposal to insured branches of foreign banks would be inconsistent with the International Banking Act which grandfathered nonbanking activities of foreign banks and their affiliates in the United States. That Act also gave the Federal Reserve Board the authority to terminate grandfather status as to any particular foreign bank after December 31, 1985 if that agency determines such action is necessary to prevent undue economic concentration, decreased competition, conflicts of interest, or unsound banking practices in the United States. The interposition of an FDIC regulation is, according to these comments, unnecessary.

After carefully weighing these comments, the FDIC has determined to exempt foreign banks and insured branches of foreign banks by defining the term "insured nonmember bank" for the purposes of § 337.4 to exclude foreign banks with insured branches in the United States. The final regulation does *not* exclude domestic insured nonmember banks that are owned by foreign banks. It should be noted, however, that inasmuch as the final regulation defines "company" to exclude a bank, the foreign bank parent of a domestic bank does not fall within the definition of the term "affiliate" which itself refers to a "company" that directly or indirectly controls an insured nonmember bank. Any nonbank subsidiaries of the parent foreign bank would qualify, however, as affiliates of the U.S. bank subsidiary. The final regulation also provides that the lending restriction contained in § 337.4(e)(3) does not apply to extensions of credit to non-U.S. companies whose securities are underwritten or distributed outside the United States by an insured nonmember bank's non-U.S. affiliate or affiliates. The regulation has been changed in this manner in order to avoid any extraterritorial effect and also because equity securities of non-U.S. companies are not ranked by any nationally recognized rating service.

15. Federal Savings Banks

FDIC received a comment from the National Council of Savings Institutions requesting that FDIC expressly set forth in the regulation that federally chartered savings banks insured by FDIC are not subject to the regulation. FDIC has not done so, however, as it is FDIC's intent to include such institutions within the scope of the regulation. (The term "insured nonmember bank" has been defined in the final regulation so as to clearly cover FDIC insured federal savings banks. (The securities activities conducted by subsidiaries and affiliates of federal savings banks can impact bank safety and soundness and ultimately the insurance fund. As the insurer of such institutions, FDIC has the authority under section 8(a) of the Federal Deposit Insurance Act (12 U.S.C. 1818(a)) and the agency's general rulemaking

authority to adopt rules and regulations applicable to such institutions designed to safeguard the insurance fund and ensure compliance with the Glass-Steagall Act.

16. Paperwork Reduction Act

The notice requirements contained in the final regulation do not constitute "collections of information" for purposes of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*) and therefore are not subject to the Office of Management and Budget ("OMB") clearance provisions of that Act. This is because the notice requirements fall within the exception to the definition of "information" set out in § 1320.7(k)(1) of OMB regulations implementing the "collection of information clearance" provisions of the Act (5 CFR Part 1320). It is recognized, however, that the notice requirements do place an affirmative obligation on a bank to notify the FDIC of its intended action, to confirm whether or not the subsidiary was acquired or established, and to notify FDIC if the subsidiary's activities are expanded. Any costs associated with these notices would appear, however, to be minimal. The final regulation does not specify the content of the written notices nor require the bank to provide any specific information. Inasmuch as the bank subsidiary will in all likelihood be filing with the SEC, no additional paperwork burdens of any kind should be created.

17. Regulatory Flexibility Analysis

In accordance with FDIC's policy statement entitled "Development and Review of FDIC Rules and Regulations" and the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), the FDIC conducted an analysis of the impact of the proposed regulation. The results of that analysis, which were published in the *Federal Register* along with the 30-day proposal, are republished below inasmuch as FDIC's conclusions drawn from the regulatory assessment of the final regulation do not differ from FDIC's conclusions with respect to the most recent proposal.

In general, participation by bank subsidiaries in the underwriting market for new securities issues offers a number of potential benefits. Bank participation will likely lower underwriting costs for issuers in a number of markets. This competitive benefit should be particularly noticeable in local and regional markets where the number of bidders for a new issue is generally small. Additionally, increased activity in the secondary market for securities will increase the liquidity of any new issue. This will increase the attractiveness of new securities issues to potential investors. The presence of new entrants in the underwriting and discount brokerage markets should increase investor awareness, provide for greater customer convenience and lower brokerage costs to investors (both for users of discount brokerage and full service brokerage services) as fee and service competition increases. All of the above factors will tend to benefit the U.S. economy as more money flows into the capital markets.

The final regulation should not interfere substantially with the realization of these potential benefits. Moreover, it should provide additional benefits in that it reduces the potential for conflicts of interest, helps to ensure that banks are adequately insulated from their subsidiaries, and prevents the subsidiaries from engaging in excessive risk taking. Furthermore, the final regulation should not, in any way, give certain competitors unfair advantage or work to the detriment of small banks.

There would be an overall cost to the economy if the advent of bank securities subsidiaries could be expected to jeopardize the viability of the nation's banking institutions. That does not appear to be the case, however, and certainly is not the case when the structure of the final regulation is taken into consideration. For example, the regulation is structured so as to insulate the bank from the activities of the subsidiary as well as any financial repercussions generated by losses on the part of the subsidiary. The bank is further insulated as it will not be able to make purpose loans, prop up companies whose securities are underwritten by the bank's subsidiary of affiliate, make excessive loans to its securities subsidiary or affiliate, invest an excessive amount of

capital in the subsidiary, or move poor issues into the bank's trust department.

Several provisions of the final regulation are designed to address the potential for conflicts of interest. It should be pointed out, however, that conflicts of interest can never be entirely eliminated. Nor would it be desirable to attempt to do so as the costs associated with excessive restrictions and government oversight would far outweigh the potential benefits from any incremental reduction in conflicts of interest.

The final regulation should not be detrimental to small banks. The absence of an investment cap in the subsidiary should enable even relatively small insured nonmember banks to indirectly compete in the securities market through a subsidiary. Moreover, there are no restrictions against joint ventures, *i.e.* more than one bank or financial institution can join together to form a securities subsidiary. The requirements that the securities business of the subsidiary and affiliate be physically separate and distinct in its operation from the operation of the bank and that a majority of the bank's officers and directors not be officers or directors of the subsidiary of affiliate, and that no officer of the bank be an officer of the subsidiary or affiliate should not be an excessive burden or small banks.

List of Subjects in 12 CFR Part 337

Banks, banking, Securities, State nonmember banks.

In consideration of the foregoing, the FDIC hereby amends Part 337 of title 12 of the Code of Federal Regulations as follows:

PART 337—UNSAFE AND UNSOUND BANKING PRACTICES

1. The authority citation for Part 337 is amended to read as follows:

Authority: Sec. 8, 64 Stat. 876, 12 U.S.C. 1816; sec. 8(a), section 2[8(a)] of the Act of September 21, 1950 (Pub. L. No. 797; 64 Stat. 879), effective September 21, 1950, as amended by

section 204 of title II of the Act of October 16, 1966 (Pub. L. No. 89-695; 80 Stat. 1054), effective October 16, 1966; section 6(c)(14) of the Act of September 17, 1978 (Pub. L. No. 95-369; 92 Stat. 618), effective September 17, 1978; and section 113(g) of title 1 of the Act of October 15, 1982 (Pub. L. No. 97-320; 96 Stat. 1473 and 1474), effective october 15, 1982; 12 U.S.C. 1818(a); sec. 8(b), Section 2[8(b)] of the Act of September 21, 1950 (Pub. L. No. 797), as added by section 202 of title II of the Act of October 16, 1966 (Pub. L. No. 89-695; 80 Stat. 1046), as amended by section 110 of title I of the Act of October 28, 1974 (Pub. L. No. 93-495; 88 Stat. 1506); section 11 of the Act of September 17, 1978 (Pub. L. No. 95-369; 92 Stat. 624); sections 107(a)(1) and 107(b) of title I of the Act of November 10, 1978 (Pub. L. No. 95-630; 92 Stat. 3649 and 3653); and sections 404(c), 425(b), and 425(c) of title IV of the Act of October 15, 1982 (Pub. L. No. 97-320; 96 Stat. 1512 and 1524); 12 U.S.C. 1818(b); sec. 9, 64 Stat. 881-882, 12 U.S.C. 1819; sec. 18(j)(2); 92 Stat. 3664, 12 U.S.C. 1828(j)(2), sec. 422, 96 Stat. 1469, (Pub. L. No. 97-320); sec. 11(a), section 2[11(a)[of the Act of September 21, 1950 (Pub. L. No. 797; 64 Stat. 884), effective September 21, 1950, as amended by section 301(c) of title III of the act of October 16, 1966 (Pub. L. No. 89-695; 80 Stat. 1055), effective October 16, 1968; section 7(a)(3) of title I of the Act of December 23, 1969 (Pub. L. No. 91-151; 83 Stat. 375) effective December 23, 1969; sections 101(a)(3) and 102(a)(3) of title I of the act of October 28, 1974 (Pub. L. No. 93-495; 88 Stat. 1500 and 1502), effective November 27, 1974; section 1401(a) of title XIV of the Act of November 10, 1978 (Pub. L. No. 95-630; 92 Stat. 3712), effective March 10, 1979; section 323 of title III of the Act of December 21, 1979 (Pub. L. No. 96-153; 93 Stat. 1120); section 308 of title III of the Act of March 31, 1980 (Pub. L. No. 96-221; 94 Stat. 147), effective March 31, 1980; and section 103 of title I of the Act of December 26, 1981 (Pub. L. No. 97-110; 95 Stat. 1514), effective December 26, 1981; sec. 11(f), section 2[11(f)] of the act of September 21, 1950 (Pub. L. No. 797; 64 Stat. 885), effective September 21, 1950, as

amended by section 6(c)(20) of the Act of September 17, 1978 (Pub. L. No. 95-369; 92 Stat. 619), effective September 17, 1978, 12 U.S.C. 1821(f).

2. Part 337 is amended by adding new § 337.4 to read as follows:

§ 337.4 Securities activities of subsidiaries of insured nonmember banks: bank transactions with affiliated securities companies.

(a) *Definitions*: for the purposes of this section,

(1) "Affiliate" shall mean any company that directly or indirectly, through one or more intermediaries, controls or is under common control with an insured nonmember bank.

(2) "Bona fide subsidiary" means a subsidiary of an insured nonmember bank that at a minimum: (i) is adequately capitalized; (ii) is physically separate and distinct in its operations from the operation of the bank;[4] (iii) does not share a common name or logo with the bank;[5] (iv) maintains separate accounting and other corporate records; (v) observes separate formalities such as separate board of directors' meetings; (vi) maintains separate employees who are compensated by the subsidiary;[6] (vii) shares no common officers with the bank; (viii) a majority of its board of directors is composed of persons who are neither directors nor officers of the bank; and (ix) conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is

4. The subsidiary must have separate offices that share no common entrance with the bank except that access to the subsidiary's and bank's offices may be through a common outer lobby or common corridor. In all instances the subsidiary's offices must be clearly identified as belonging to the subsidiary.

5. This requirement shall not prohibit the subsidiary from advertising or otherwise disclosing its relationship to the insured nonmember bank.

6. This requirement shall not be construed to prohibit the use by the subsidiary of bank employees to perform functions which do not directly involve customer contact such as accounting, data processing and recordkeeping, so long as the bank and the subsidiary contract for such services on terms and conditions comparable to those agreed to by independent entities.

a separate organization from the bank and that investments recommended, offered or sold by the subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

(3) "Company" shall mean any corporation (other than a bank), any partnership, business trust, association, joint venture, pool syndicate, or other similar business organization.

(4) "Control" shall mean the power to directly or indirectly vote 25 per centum or more of the voting stock of a bank or company, the ability to control in any manner the election of a majority of a bank's or company's directors or trustees, or the ability to exercise a controlling influence over the management and policies of a bank or company.

(5) "Extensions of credit" shall mean the making or renewal of any loan, a draw upon a line of credit, or an extending of credit in any manner whatsoever and includes, but is not limited to:

(i) A purchase, whether or not under repurchase agreement, of securities, other assets, or obligations;

(ii) An advance by means of an overdraft, cash item, or otherwise;

(iii) Issuance of a standby letter of credit (or other similar arrangement regardless of name or description);

(iv) An acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which a natural person or company may be liable as maker, drawer, endorser, guarantor, or surety;

(v) A discount of promissory notes, bills of exchange, conditional sales contracts, or similar paper, whether with or without recourse;

(vi) An increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for (A) accrued interest or (B) taxes, insurance, or other expenses incidental to the existing indebtedness; or

(vii) Any other transaction as a result of which a natural person or company becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or

indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.

(6) "Insured nonmember bank" shall mean state and federally chartered banks insured by FDIC that are not members of the Federal Reserve System. The term shall not include foreign banks with insured branches in the United States nor insured branches of foreign banks.

(7) "Investment quality debt security" shall mean a marketable obligation in the form of a bond, note, or debenture that is rated in the top four rating categories by a nationally recognized rating service or a marketable obligation in the form of a bond, note, or debenture the investment characteristics of which are equivalent to the investment characteristics of such a top-rated obligation.

(8) "Investment quality equity security" shall mean marketable common stock that is ranked or graded in the top four categories or equivalent categories by a nationally recognized rating service, marketable preferred corporate stock that is rated in the top four rating categories by a nationally recognized rating service, or marketable preferred corporate stock that has investment characteristics that are equivalent to the investment characteristics of top rated preferred corporate stock.

(9) "Subsidiary" shall mean any company controlled by an insured nonmember bank.

(b) *Investment in securities subsidiaries.* (1) An insured nonmember bank may not establish or acquire a subsidiary that engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes or other securities; conducts any activities for which the subsidiary is required to register with the Securities and Exchange Commission as a broker/dealer; acts as an investment adviser to any investment company; or engages in any other securities activity unless:

(i) Except as otherwise provided by § 337.4(b)(2), the subsidiary's underwriting activities that would not be authorized to the bank under section 16 of the Glass-Steagall Act (12 U.S.C. 24 (Seventh)) as made applicable to insured nonmember banks

by section 21 of the Glass-Steagall Act (12 U.S.C. 378) are limited to, and thereafter continue to be limited to, one or more of the following: (A) Underwriting of investment quality debt securities; (B) underwriting of investment quality equity securities; (C) underwriting of investment companies not more than 25 percent of whose investments consist of investments other than investment quality debt securities and/or investment quality equity securities; or (D) underwriting of investment companies not more than 25 percent of whose investments consist of investments other than obligations of the United States or United States Government agencies, repurchase agreements involving such obligations, bank certificates of deposit, banker's acceptances and other bank money instruments, short-term corporate debt instruments, and other similar investments normally associated with a money market fund; and

(ii) The subsidiary is, and thereafter continues to be, a bona fide subsidiary if that subsidiary conducts securities activities not authorized to the bank under section 16 of the Glass-Steagall Act as made applicable to insured nonmember banks by section 21 of the Glass-Steagall Act.

(2) Paragraph (b)(1)(i) of this section notwithstanding, a subsidiary of an insured nonmember bank may engage in underwriting activities other than as limited thereby provided that the following conditions are met:

(i) The subsidiary is a member in good standing of the National Association of Securities Dealers ("NASD");

(ii) The subsidiary has been in continuous operation for the five year period preceding notice to the FDIC as required by this part;

(iii) No director, officer, general partner, employee, or 10 percent shareholder of any class of voting securities of the subsidiary has been convicted within five years of the notice required by this part of any felony or misdemeanor in connection with the purchase or sale of any security involving the making of a false filing with the Securities and Exchange Commission or arising

out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser;

(iv) Neither the subsidiary nor any of its directors, officers, general partners, employees, or 10 percent shareholders of any class of voting securities of the subsidiary is subject to any state or federal administrative order or court order, judgment, or decree entered within five years of the notice required by this part temporarily or preliminarily enjoining or restraining such person or the subsidiary from engaging in, or continuing, any conduct or practice in connection with the purchase or sale of any security involving the making of a false filing with the Securities and Exchange Commission or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser;

(v) None of the subsidiary's directors, officers, general partners, employees, or 10 percent shareholders of any class of voting securities of the subsidiary are subject to an order entered within five years of the notice required by this part of the Securities and Exchange Commission entered pursuant to section 15(b) or 15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o, 78o-4) or section 203(c) or (f) of the Investment Advisors Act of 1940 (15 U.S.C. 80b-3(c), (f)); and

(vi) All officers of the subsidiary who have supervisory responsibility for underwriting activities have at least five year experience in similar activities at NASD member securities firms.

(3) An insured nonmember bank's direct investment in a securities subsidiary described in paragraphs (b)(1) or (b)(2) of this section will not be counted toward the bank's capital.

(c) *Affiliation with a securities company.* An insured nonmember bank is prohibited from becoming affiliated with any company that directly engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities unless: (1) The securities business of the affiliate is physically separate and distinct from the operation of the bank;[7] (2) the

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7. The affiliate must have separate offices that share no common entrance with the bank except that access to the affiliate's and bank's offices may be

bank and affiliate share no common officers; (3) a majority of the board of directors of the bank is composed of persons who are neither directors nor officers of the affiliate; (4) any employee of the affiliate who is also an employee of the bank does not conduct any securities activities on behalf of the affiliate on the premises of the bank that involve customer contact; (5) the bank and affiliate do not share a common name or logo;[8] and (6) the affiliate conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate that the affiliate is a separate organization from the bank and that investments recommended, offered or sold by the affiliate are not bank deposits, are nor insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.[9]

(d) *Filing of notice.* Every insured nonmember bank that intends to acquire or establish a subsidiary that (1) engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities; (2) acts as an investment adviser to any investment company; (3) conducts any activity for which the subsidiary is required to register with the Securities and Exchange Commission as a broker/dealer; or (4) engages in any other securities activity, shall notify the regional director of the FDIC region in which the bank is located of such intent. Notice shall be in writing and must be received in the regional office at least 60 days prior to consummation of the acquisition or commencement of the operation of the subsidiary, whichever is earlier. The bank shall also notify the regional office in writing within 10 days after the consummation of the acquisition or commencement of the operation of the subsidiary, whichever is earlier. The 60-day notice requirement may be waived in FDIC's discretion where such notice is impracticable such as in the case

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through a common outer lobby or common corridor. In all instances the affiliate's offices must be clearly identified as belonging to the affiliate.

8. This requirement shall not prohibit the bank from advertising or otherwise disclosing its relationship to the affiliate.

9. This requirement shall not be construed to prohibit the affiliate from brokering deposits to the extent and in the manner as otherwise permitted by statute and regulation.

of a purchase and assumption transaction or an emergency merger. Where the above notices pertain solely to the transfer of securities activities previously performed by the bank to the subsidiary, an additional written notice must be filed with the regional office if the subsidiary commences any securities activity covered by § 337.4(b)(1)(i) or (b)(2) of this part. This notice must be received in the regional office within thirty days after the subsidiary commences the new activity. If the 60-day advance notice and 10-day follow-up notice pertain to the establishment or acquisition of a subsidiary that engages in underwriiting activities as limited by § 337.4(b)(1)(i), an additional written notice must be filed with the regional office if the subsidiary commences underwriting activities as permitted by § 337.4(b)(2) of this part. This notice must be received in the regional office within thirty days after the subsidiary commences the new activity.

(e) *Restrictions.* An insured nonmember bank which has a subsidiary or affiliate that engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities, or acts as an investment adviser to any investment company shall not:

(1) Purchase in its discretion as fiduciary, co-fiduciary, or managing agent any security currently distributed, currently underwritten, or issued by such subsidiary or affiliate or purchase as fiduciary, co-fiduciary, or managing agent any security currently issued by an investment company advised by such subsidiary or affiliate, unless (i) the purchase is expressly authorized by the trust instrument, court order, or local law, or specific authority for the purchase is obtained from all interested parties after full disclosure, (ii) the purchase, although not expressly authorized under paragraph (e)(1)(i) of this section, is otherwise consistent with the insured nonmember bank's fiduciary obligation, or (iii) the purchase is permissible under applicable federal and/or state statute or regulation;

(2) Transact business through its trust department with such subsidiary or affiliate unless the transactions are at least comparable to transactions with unaffiliated securities company or a securities company that is not a subsidiary of the bank;

(3) Extend credit or make any loan directly or indirectly to any company the stocks, bonds, debentures, notes or other securities of which are currently underwritten or distributed by such subsidiary or affiliate of the bank unless the company's stocks, bonds, debentures, notes or other securities that are underwritten or distributed (i) qualify as investment quality debt securities, or (ii) qualify as investment quality equity securities;[10]

(4) Extend credit or make any loan directly or indirectly to any investment company whose shares are currently underwritten or distributed by such subsidiary or affiliate of the bank;

(5) Extend credit or make any loan where the purpose of the extension of credit or loan is to acquire (i) any stock, bond, debenture, note, or other security currently underwritten or distributed by such subsidiary or affiliate; (ii) any security currently issued by an investment company advised by such subsidiary or affiliate; or (iii) any stock, bond, debenture, note, or other security issued by such subsidiary or affiliate, except that a bank may extend credit or make a loan to employees of the subsidiary or affiliate for the purpose of acquiring securities of such subsidiary or affiliate through an employee stock bonus or stock purchase plan adopted by the board of directors or board trustees of the subsidiary or affiliate;[11]

(6) Make any loan or extension of credit to a subsidiary or affiliate of the bank that (i) distributes or underwrites stocks,

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10. This restriction shall not be construed to prohibit the bank from honoring a loan commitment or revolving loan agreement or funding a line of credit where the loan commitment, revolving loan agreement, or line of credit was entered into prior in time to the underwriting or distribution. This restriction does not apply to any extension of credit to a non-U.S. company whose securities are underwritten or distributed outside the United States by a non-U.S. affiliate of an insured nonmember bank.

11. In complying with § 337.4(e)(5) of this Part, the bank shall be entitled to rely in good faith on the customer's statement as to the purpose of the extension of credit or loan.

bonds, debentures, notes, or other securities, or (ii) advises any investment company, if such loans or extensions of credit would be in excess of the limit as to amount, and not in accordance with the restrictions imposed on "covered transactions" by section 23A of the Federal Reserve Act (12 U.S.C. 371c) and that are not within any exemptions established thereby;

(7) Make any loan or extension of credit to any investment company for which the bank's subsidiary or affiliate acts as an investment adviser if the loan or extension of credit would be in excess of the limit as to amount, and not in accordance with the restrictions imposed on "covered transactions" by section 23A of the Federal Reserved Act and that are not within any exemptions established thereby; and

(8) Directly or indirectly condition any loan or extension of credit to any company on the requirement that the company contract with, or agree to contract with, the bank's subsidiary or affiliate to underwrite or distribute the company's securities or directly or indirectly condition any loan or extension of credit to any person on the requirement that that person purchase any security currently underwritten or distributed by the bank's subsidiary or affiliate.[12]

(f) Nothing in this section prohibits an insured nonmember bank from establishing or acquiring a subsidiary that sells, distributes, or underwrites stocks, bonds, debentures, notes, or other securities or engages in any other securities activity if those activities would be permitted to an insured nonmember bank by sections 16 and 21 of the Glass-Steagall Act (12 U.S.C. 24 (Seventh) and 378).

(g) Nothing in this section authorizes an insured nonmember bank to directly engage in any securities activity not authorized to it under sections 16 and 21 of the Glass-Steagall Act (12 U.S.C. 24 (Seventh) and 378).

12. An insured nonmember bank in complying with the requirements of § § 337.4(e)(1), (e)(3), and (e)(4) of this part concerning "current" underwritings and distributions may rely upon the affiliate's or subsidiary's statement that the underwriting or distribution of any particular security has terminated.

(h) An insured nonmember bank that prior to [insert effective date of regulation] became affiliated with a securities company or prior to that date established or acquired a subsidiary that engages in securities activities, shall have two years from December 28, 1984 to bring itself into compliance with § 337.4 of this Part, except that, such bank must comply with paragraphs 337.4(b)(1)(ii), 337.4(c) and 337.4(e) as soon as practicable (but not more than one year from [insert effective date of regulation] without the FDIC's consent) and must inform the regional director of the FDIC region in which the bank is located not later than 30 days after December 28, 1984 that the bank is affiliated with a company that engages in securities activities or has a subsidiary that engages in securities activities.

By Order of the Board of Directors, 19th day of November 1984.

Federal Deposit Insurance Corporation.

Hoyle L. Robinson,
Executive Secretary.

[FR Doc. 84-31144 Filed 11-27-84: 8:45 am)

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Federal Register/Vol. 49, No. 85/Tuesday, May 1, 1984
Proposed Rules/18,497

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 337
Unsafe and Unsound Banking Practices

AGENCY: Federal Deposit Insurance Corporation ("FDIC").

ACTION: Proposed rule.

SUMMARY: The FDIC has determined that it is not unlawful under the Glass-Steagall Act for an insured nonmember bank to establish or acquire a bona fide subsidiary that engages in securities activities nor for an insured nonmember bank to become affiliated with a company engaged in securities activities. At the same time, however, the FDIC has found that some risk may be associated with those activities. In order to address that risk and to ensure the legality of insured nonmember bank indirect involvement in securities activities, the FDIC is proposing to amend its regulations to (1) define bona fide subsidiary, (2) limit an insured nonmember bank's permissible direct and indirect investments in its securities subsidiary or subsidiaries, (3) require notice of intent to invest in a securities subsidiary, (4) limit the permissible securities activities of insured nonmember bank subsidiaries, and (5) place certain other restrictions on loans, extensions of credit, and other transactions between insured nonmember banks and their subsidiaries of affiliates that engage in securities activities. This action is a continuation of a rulemaking initiated by the FDIC on May 9, 1983 with the adoption of a proposed amendment to Part 337 which was published for public comment at 48 FR 22155.

DATE: Comments must be received by May 31, 1984.

ADDRESS: Send comments to Hoyle L. Robinson, Executive Secretary, Federal Deposit Insurance Corporation, 550 17th

Street, NW, Washington, D.C. Comments may be hand delivered to Room 6108 between the hours of 8:30 a.m. and 5:00 p.m.

FOR FURTHER INFORMATION CONTACT: Pamela E.F. LeCren, Senior Attorney, Legal Division, (202-389-4171), Room 4126 E, 550 17th Street, N.W., Washington, D.C. 20429

SUPPLEMENTARY INFORMATION: On August 23, 1982, the Board of directors of the FDIC adopted a policy statement concerning the applicability of the Glass-Steagall Act to securities activities of subsidiaries of nonmember banks. The policy statement, which was published in the Federal Register on September 3, 1982 (47 FR 38984), concluded that, in the opinion of the Board of Directors, the Banking Act of 1933 (popularly known as the Glass-Steagall Act and codified in various provisions of title 12 of the United States Code) does not by its express terms prohibit an insured nonmember bank from establishing an affiliate relationship with or organizing or acquiring a subsidiary corporation that engages in the business of issuing, underwriting, selling or distributing stocks, bonds, debentures, notes, or other securities. Although the policy statement was not designed to address the safety and soundness of such activities, it did state that the FDIC recognized its ongoing responsibility to ensure the safe and sound operation of insured nonmember banks and that, depending on the facts, potential risks can be inherent in a bank subsidiary's involvement in particular securities activities.

In keeping with that statement, the FDIC on September 20, 1982 adopted an Advance Notice of Proposed Rulemaking (47 FR 42121) designed to solicit comment on the need, if any, for rulemaking with regard to securities activities of affiliates and subsidiaries of insured nonmember banks. After carefully reviewing the comments received in response to that notice and after reviewing in conjunction therewith the purposes of the Glass-Steagall Act as articulated in the Act's legislative history and recent case law construing the Act, the FDIC adopted on May 9, 1983 a proposed regulation (May, 1983 proposal) addressing the securities activities of subsidiaries and affiliates of insured nonmember banks. As stated in the preamble to the

May, 1983 proposal (48 FR 22155), "[The] proposal is a recognition by the FDIC that at least some of [the] hazards [contemplated by the Glass-Steagall Act] can and do exist [when a bank is indirectly involved in securities activities] even though, in the FDIC's opinion, a bank's involvement in securities activities is not unsafe or unsound in all instances. * * * Rather than deny insured nonmember banks the opportunity of acquiring or forming securities subsidiaries because of the presence of some risk, the FDIC is proposing to eliminate or lessen the risks that can be present by placing a number of restrictions on a nonmember bank's indirect involvement in the securities area."

The basic features of the May 1983 proposal were as follows: (1) A requirement that a bank give FDIC notice of intent to invest in a securities subsidiary; (2) a prohibition on an insured nonmember bank establishing or acquiring a subsidiary that underwrites securities unless the underwriting activity is done on a best-efforts basis, is the underwriting of top rated debt securities, and/or is the underwriting of a money market type mutual fund; (3) a limit on the bank's investment in one or more securities subsidiaries to twenty percent of the bank's equity capital; (4) a limit on the amount of loans or other extensions of credit the bank can make to its securities subsidiary or affiliate; (5) a prohibition on the bank making loans to any customer where the purpose of the loan is to acquire securities currently being underwritten or distributed by the bank's subsidiary or affiliate or accepting such securities as collateral on a loan or other extension of credit; (6) a prohibition on the bank directly or indirectly making loans or other extensions of credit to companies whose securities are currently being underwritten or distributed by the bank's subsidiary or affiliate if those securities are not rated in the top four rating categories by a nationally recognized rating service; (7) a prohibition on the bank as trustee purchasing in its sole discretion any security currently being underwritten, distributed, or issued by the bank's subsidiary or affiliate or any security currently being underwritten, distributed, or issued by any investment company advised by the bank's subsidiary or affiliate; and

(8) a prohibition on the bank transacting business through its trust department with the bank's securities subsidiary or affiliate unless the transactions are comparable to transactions with an unaffiliated securities company.

Additionally, the May 1983 proposal defined the term "bona fide subsidiary" as a subsidiary of an insured nonmember bank that at a minimum (i) is adequately capitalized; (ii) is physically separate in its operations from the operation of the bank; (iii) maintains separate accounting and other corporate records; (iv) observes separate formalities such as separate board of directors meeting; (v) maintains separate employees who are compensated by the subsidiary; and (vi) conducts business separately from functions independently of, and is not identified with, the banking business of the insured nonmember bank.

The May proposal was published for a sixty-day comment period which ended on July 18, 1983. In addition to inviting written comments during that time period, the FDIC invited oral testimony at a one-day public hearing that was held on June 17, 1983. The FDIC received 35 written comments and heard oral testimony from two witnesses at the June 17 public hearing. Because of the complexity of the issues involved and the relatively small number of comments received during the comment period, the FDIC has determined to issue a revised proposed regulation. The new proposed regulation was formulated after carefully reviewing the written comments as well as testimony given before various congressional committees that was given directly in connection with, or was relevant to, FDIC's rulemaking. The written and oral comments as well as the testimony given before Congress are summarized below where relevant to an explanation of the new proposed regulation.

1. Bona Fide Subsidiary

The term "bona fide subsidiary" as proposed for comment required at a minimum that the subsidiary (i) be adequately capitalized; (ii) be physically separate in its operations from the operation of the bank; (iii) maintain separate accounting and

other corporate records; (iv) observe separate formalities such as separate board of directors' meetings; (v) maintain separate employees who are compensated by the subsidiary; and (vi) conduct business separately from, function independently of, and not be identified with, the banking business of the insured nonmember bank.

In proposing the above definition the FDIC indicated that it was not necessarily implying that any association between a bank and its securities subsidiary in the public's mind could harm the reputation of the bank but rather that the FDIC was attempting to ensure the separateness of the subsidiary and the bank. Inasmuch as the bank would be prohibited by the Glass-Steagall Act from engaging in many activities the subsidiary might undertake, the separation is essential. If a bank's subsidiary is not sufficiently distinct from its parent, the subsidiary may be found to be an alter ego or a mere instrumentality of the bank and the bank held to be engaging in securities activities in violation of the Glass-Steagall Act. The definition was also designed to ensure the separateness of the subsidiary from the bank as a means of safeguarding the soundness of the parent bank. As stated in the proposal, "the parent bank is less likely to be harmed if the subsidiary has adequate capital and thus can itself absorb losses as well as liabilities arising from the securities operation."

The proposed regulation adopts a definition of "bona fide subsidiary" that is substantially the same as that which was originally proposed for comment with a few significant revisions. The proposed definition retains the requirement found in the May 1983 proposal that the subsidiary be adequately capitalized. This requirement was generally viewed as proper by those commenting on the May 1983 proposal. The Investment Company Institute ("ICI") in commenting unfavorably on the May 1983 proposal did, however, opine that the parent bank could not be sufficiently insulated from the subsidiary's financial losses nor the possibility of liability under the securities laws regardless of to what degree the subsidiary is capitalized. After considering this comment, we agree that a parent bank may be considered a

"controlling person" of the securities subsidiary and thus *potentially* subject to liability to the same extent as the subsidiary for any violations of the securities laws on the part of the subsidiary. That liability is not absolute, however. The bank as a "controlling person" may not be liable if it had no knowledge of the circumstances which gave rise to the violation, the bank acted in good faith, and the bank did not directly or indirectly induce the violation. We therefore have concluded that it is possible to structure the relationship between a parent bank and its subsidiary to avoid or lessen the bank's exposure under the securities laws for the acts of the subsidiary.

Although the proposed regulation requires that the subsidiary be adequately capitalized, it does not define what constitutes adequate capital. No definition has been incorporated in the proposed regulation as the adequacy of any particular subsidiary's capital can vary from a safety and soundness point of view. The FDIC maintains the position previously stated in the May, 1983 proposal that the bank's subsidiary must, at a minimum, comply with any applicable capital requirements imposed by the Securities and Exchange Commission ("SEC") or imposed under State law. That level of capital is merely a starting point, however, and the FDIC reserves the right to determine that the subsidiary's activities and/or the parent bank's condition warrant that the subsidiary be capitalized over and above any such requirement. It is FDIC's intention to make this assessment during the "notice" period (see subsection (d) of the proposed regulation discussed below) and to inform the bank at that time whether in FDIC's opinion the capital position of the subsidiary is adequate. It is FDIC's belief that such a flexible approach will better serve FDIC's supervisory interest in maintaining the safety and soundness of insured nonmember banks.

The proposed definition also retains the requirement found in the May, 1983 proposal that the subsidiary maintain separate accounting and other corporate records and that the subsidiary observe separate formalities such as separate board of directors' meeting. Also retained is the requirement that the subsidiary

maintain separate employees who are compensated by the subsidiary. In addition, however, bank employees will be permitted, under the proposal, to perform so-called "back office" operations (such as accounting, data processing, and recordkeeping), provided the bank is fully compensated for such services in an arm's-length transaction. Comment is specifically directed to whether the language in footnote 4 of the proposed regulation which contains this exception can or should be further clarified.

The separate employee requirement was criticized in a substantial number of comments in response to the May, 1983 proposal. The comments observed that the requirement would be costly and inefficient, would prevent the bank subsidiary from entering the securities area slowly, and would prevent the bank from making available to the subsidiary the expertise of bank personnel already familiar with securities operations. The FDIC acknowledges that the separate employee requirement can produce some additional costs to insured nonmember banks but anticipates that the exception contained in the proposed regulation for back office operations (*i.e.*, allowing bank employees to perform administrative, noncustomer contact type activities) reduces the inefficiency and added costs that might otherwise be produced. The requirement has also been retained in the proposed regulation as it felt that the use of separate employees in customer contact positions is an extremely important factor in maintaining the separate corporate identity of the subsidiary and the bank. Comment is specifically requested concerning the separate employee requirement and the "back office" exception and the problems, ramifications, and burdens, etc. that might be associated therewith.

The proposed regulation retains the basic requirement as set forth in the May, 1983 proposal that the subsidiary's operation be separate from the operation of the bank. The wording has been changed to require that "physically separate" operation of a subsidiary means the securities subsidiary is not located on the same floor of a banking building where deposits are received. FDIC's purpose in changing the wording of the definition is to more

clearly demaracate the bank's depository business from its subsidiary's securities business and to prevent customer confusion regarding the separation. As several commenters expressed concern over the requirement for a physically separate facility and recommended that a separate facility is not necessary so long as the manner in which the subsidiary's operation is conducted makes clear to the customer with whom he or she is dealing, we are specifically inviting comment on the problems, ramifications, and burdens that the above restriction might generate. The FDIC also particularly invites comments on whether sufficient separation can be maintained without requiring "physical separation", and, if so, how such a distinction of operations could be maintained if the same physical quarters were used for both operations. Lastly, in order to clearly provide that the subsidiary's operations be distinct from the parent bank's, the proposed definition of bona fide subsidiary has been reworded to require that the subsidiary "conduct business pursuant to policies and procedures independent from the bank so that customers of the subsidiary are aware that the subsidiary is a separate organization from the bank and that investments recommended, offered or sold by the subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank."

The proposed definition expressly requires that the subsidiary not share a common name or logo with the bank. Name identification is a factor used by the courts in deciding whether to pierce the corporate veil, is a factor in public identification of the securities operation with the bank, plays a role in the public's misconception as to the insured status of investments placed with the subsidiary, and plays a role in engendering an expectation that the bank is liable for the obligations of the subsidiary. Additionally, as stated in one comment, a bank may be reluctant to allow a subsidiary to fail if that subsidiary carries the bank's name. For these reasons the FDIC continues to propose to prohibit the use of a common name or logo with the bank despite comments urging that we not do so. Furthermore, the FDIC does not feel at this

time that the above restriction will competitively harm insured nonmember bank subsidiaries. We wish to specifically direct comment, however, to what problem, ramifications , burdens etc. might be generated by prohibiting the use of common names or logos.

Insured nonmember banks should note that if the subsidiary *only* conducts activities that the bank itself could conduct, the need for the subsidiary to not be identified with the bank in order to avoid a Glass-Steagall Act violation is eliminated. The FDIC, however, still intends at this time to require that there be sufficient differentiation between the bank and its subsidiary in its name, advertisements, promotions, etc. so as to avoid any public misconception as to the insured status of any accounts or other investments held by the subsidiary.

The proposed definition also requires that the subsidiary not share common officers with the bank and that a majority of its board of directors not be directors or officers of the bank. The officer/director requirement is being expressly added to the proposed definition in order to: (1) Ensure that the subsidiary operates independently from the parent bank, and (2) reduce the likelihood under the "controlling person" doctrine (see above) that the parent bank may be held liable for any securities laws violations on the part of the subsidiary. We would like to receive comment on the problems, ramifications, burdens, etc. that the requirement might generate.

2. Underwriting

The May 1983 proposal would have prohibited an insured nonmember bank from establishing or acquiring a subsidiary that underwrites securities unless the subsidiary's underwriting activities in which the bank itself could not lawfully engage were limited to: (1) The underwriting of investment quality debt securities (either on a firm commitment or best-efforts basis); (2) the underwriting of money market fund type mutual funds; and/or (3) the underwriting of any security other than an investment quality debt security (e.g., equity securities) on a best-

efforts basis. The term "investment quality debt security" was defined in the May, 1983 proposal as a marketable obligation in the form of a bond, note, or debenture the investment characteristics of which are not predominately speculative. The definition specifically included obligations rated by a nationally recognized rating service that were rated in the top four rating categories. As stated in the May, 1983 proposal, FDIC's intent in limiting equity underwriting to a best-efforts basis was to insulate the parent bank from whatever risks might be associated with those underwritings. The insulation presumably would result from the fact that the best-efforts underwriter does not agree to purchase any unsold portion of an issue but only agrees to use best-efforts to sell the securities.

A substantial portion of the overall comments the FDIC received in regard to the May, 1983 proposal were directed to the provision described above. A number of comments objected to the decision to differentiate in the treatment of insured nonmember bank subsidiaries depending upon the type of of securities underwritten by the subsidiary. These comments went on to express the view that the critical factor is not the activity conducted by the subsidiary, but rather how well the subsidiary is capitalized, the level of experience of its personnel, and whether or not the subsidiary follows prudent management practices. These comments, as well as others, advised the FDIC to permit debt and equity underwriting on a firm commitment basis and to eliminate the best-efforts restriction. The reasons cited were: (1) Retaining the best-efforts restriction will effectively preclude insured nonmember bank subsidiaries from the equity underwriting market; (2) a firm commitment underwriting is arguably less risky than a best-efforts underwriting as traditionally only marginal issues are underwritten on a best-effort basis; and (3) practically speaking, there is no greater risk in a firm commitment underwriting than in a best-efforts underwriting as, in the case of the former, most of the issue is presold.

Most of the comments addressing the best-efforts issue (as well as SEC Commissioners Shad and Longstreth in their testimony

before Congress) criticized the best-efforts restriction. The criticism primarily focused on the fact that rather than protecting the parent bank, the best-efforts restriction could potentially harm the bank. That criticism can be summarized as follows: (1) The restriction will force nonmember banks to be identified through their subsidiaries with marginal firms that have a greater failure rate and whose securities are typically of a lower quality; (2) as it is customary for underwriters to make after-markets, the bank's subsidiary may end up purchasing the securities even though it is not contractually obligated to do so; (3) as the nonmember bank's subsidiary could not effectively compete if the best-efforts restriction is retained, the subsidiary may find ways around the restriction and thus expose the bank to greater risks; and (4) best-efforts underwriting will expose the bank's subsidiary to due diligence litigation.

The FDIC also received comments to the May, 1983 proposal as follows: (1) The ban on mutual fund underwriting is too restrictive, (2) the FDIC should permit insured nonmember banks to underwrite mutual funds that invest in top quality equity securities and top quality debt securities, (3) the loss experience associated with underwriting equity issues is no greater than that associated with underwriting debt issues, and (4) several comments (including the comments of SEC Commissioner Shad in his Congressional testimony) indicating that debt issues are not risk free as modest market declines can eliminate the underwriting spreads on investment quality debt issues. With the exception of comments falling within item four, and putting aside the comments that challenged the entire rulemaking posture (the FDIC received nine such comments), FDIC did not receive any comments suggesting that bank subsidiaries should be precluded from underwriting investment quality debt securities.

The FDIC proposed regulation reflects several revisions that are based upon the above comments. The proposed regulation permits an insured nonmember bank to establish or acquire a subsidiary that underwrites investment quality debt securities, underwrites investment quality equity securities (see discussion

in paragraph 3 below), underwrites mutual funds that invest exclusively in investment quality equity securities and/or investment quality debt securities, and/or underwrites money market fund type mutual funds. The proposed regulation thus eliminates the catch-all found in the May, 1983 proposal that would have permitted the bank's subsidiary to underwrite any security on a best-efforts basis. The FDIC was convinced upon a reading of the comments that the best-efforts aspect of the May, 1983 proposal would not have provided the insulation to insured nonmember banks that it was intended to provide. Inasmuch as the restriction did not appear to provide any benefit to insured nonmember banks, but in fact may have been detrimental, the restriction has been eliminated in the proposed regulation.

While the proposed regulation still permits equity underwriting, it is actually more conservative than the May, 1983 proposal in that it limits the ability of the bank's subsidiary to underwrite securities solely to investment quality equities. Such securities are normally traded on an exchange thus eliminating the problem raised by several comments that, as an underwriter, the bank subsidiary may be forced to make an after-market for the securities it underwrites. Even if the subsidiary were to do so, as the only securities that may be underwritten are high quality securities, the market making should not create any undue risk.

By permitting the bank's subsidiary to underwrite mutual funds that invest exclusively in one or both types of investment quality securities the proposed regulation is simply treating the activity as an indirect underwriting of securities eligible for direct underwriting. The proposed regulation would not permit the underwriting of mutual funds that are more speculative in nature; *i.e.*, whose value per share tend to fluctuate due to the nature of the investments (commodities, future contracts, oil leases). Nor would the proposed regulation permit the bank's subsidiary to underwrite any debt or equity security if that security is not of investment quality.

The proposed regulation does not restrict a nonmember bank's affiliation with a securities company depending upon the activities

conducted by that company as it does in the case of the bank's subsidiary. The FDIC did receive one comment in response to the May, 1983 proposal stating that the need to limit underwriting is just as important in the case of affiliates as in the case of bank subsidiary. The FDIC is still of the opinion, however, that there is less of a possibility that losses suffered by the bank's parent or sister affiliate due to underwriting activities will adversely impact the bank. This is so especially if the parent's ability to move funds out of the bank is limited as under the proposed regulation.

3. Investment Quality Debt Security/Investment Quality Equity Security

The May, 1983 proposal defined the term "investment quality debt security" to mean a marketable obligation in the form of a bond, note,or debenture the investment characteristics of which are not predominantly speculative and was specifically said to include obligations rated in the top four rating categories by a nationally recognized rating service. The definition as revised in the proposed regulation reads as follows: " 'Investment quality debt security' shall mean a marketable obligation in the form of a bond, note, or debenture that is rated in the top four rating categories by a nationally recognized rating service or a marketable obligation in the form of a bond, note, or debenture the investment characteristics of which are equivalent to the investment characteristics of such a top rated obligation." The revised proposed definition responds to comments to the May, 1983 proposal that the phrase "speculative investment characteristics" is overly vague and to comments which indicated that by limiting the definition of investment quality debt securities to rated securities, the FDIC may foreclose access to capital markets by smaller companies. The revised proposed definition allows a bank subsidiary to underwrite debt securities that are of comparable quality to highly rated debt securities. As the nonrated debt obligations must still be of high quality in order for the bank's subsidiary to engage in the underwriting, the FDIC does not feel

that the change in the definition will expose the parent bank to any additional risks.

The proposed regulation defines the term "investment quality equity security" to mean a marketable common or preferred corporate stock that is rated medium grade, average, or better by a nationally recognized rating service. As the science of rating equity securities is not as precise as the science of rating debt securities, nor is it as developed, the proposed definition of investment quality equity security does not contain a similar reference to nonrated equities that have equivalent investment characteristics to top rated equities. Although this definition will permit insured nonmember bank subsidiaries less flexibility in the underwriting of equity securities, the FDIC feels that this prudential restriction is warranted.

4. Filing of Notice

The proposed regulation retains the requirement found in the May, 1983 proposal that the bank give the appropriate FDIC regional office written notice of intent to establish or acquire a subsidiary that engages in any securities activity at least 60 days prior to consummation of the acquisition or commencement of the operation of the subsidiary, whichever is earlier. The proposed regulation also requires that in addition to the 60-day advance notice, a bank must file a written follow-up notice with the appropriate FDIC regional office within 10 days after the acquisition is consummated or the subsidiary commences operation, whichever is earlier. The proposed regulation does not specify the content of the written notice of intent. By not specifying the content of the notice, the FDIC is permitting a bank to satisfy the notice requirement in any way it finds most convenient. For example, if the subsidiary will be registered with the SEC, a copy of the SEC filing may simply be forwarded to the appropriate FDIC regional office. The FDIC is thus rejecting several comments in response to the May 1983 proposal which suggested that the content of the notice be specifically set forth in the regulation.

The notice provision in the proposed regulation contains one additional requirement not contained in the May 1983 proposal. Where the 60-day advance notice pertains solely to an instance where a bank transfers to its subsidiary securities activities previously performed by the bank, the bank is required under the proposed regulation to file an additional notice with the regional office if the subsidiary expands into restricted activities; *i.e.*, the underwriting activities referenced in subparagraph (b)(1)(i) of the proposed regulation. This notice serves as a supervisory mechanism which will apprise FDIC of which insured nonmember banks are conducting securities activities through their subsidiaries which pose potential risks to which the bank would not otherwise be exposed. The subsequent notice is a one-time notice; *i.e.*, the first time the subsidiary commences any activity covered by subparagraph (b)(1)(i), notice must be filed. No subsequent notice is required if the subsidiary later begins another covered underwriting activity that was not the activity which triggered the above notice.

It is the FDIC's intent to use the notices required by the proposed regulation as a point of reference. The regional office will contact the bank seeking further information if the bank's condition or other facts warrant a closer review. It is for this reason that the proposed regulation requires that the initial notice be received at least 60 days in advance. The 60-day notice can be waived at the FDIC's discretion where such period is impractical; *e.g.*, where the acquisition is the result of a purchase and assumption transaction or an emergency merger. The subsequent notice must be received in the regional office within 30 days after the subsidiary commences the triggering underwriting activity. Prior notice is not required in this instance as it was felt to do so would be too impractical and would interfere unduly in the day-to-day operations of the subsidiary. None of the proposed notice requirements are an approval process although the FDIC would not be precluded from intervening in an intended acquisition or establishment of a subsidiary or from objecting to the expansion of activities if such intervention or objection were warranted, for

example, if the subsidiary would not appear to meet the requirements for a bona fide subsidiary or the bank's investment in the subsidiary would appear to exceed the limits set by the proposed regulation.

The proposed regulation does not require a written notice when a bank becomes affiliated with a securities company. For the most part, affiliation with a securities company will arise out of a change in bank control or come to FDIC's attention when a bank seeks deposit insurance. As the FDIC will become aware of the affiliation prior to consummation in both instances, there is no need to create an additional notice requirement.

5. Lending Restrictions

The May 1983 proposal contained a number of restrictions designed to prevent abuse of a bank's credit facilities. As stated in the preamble to the May, 1983 proposal, such abuse can arise in several ways; *e.g.*, the making of imprudent loans to companies whose securities are underwritten or distributed by the bank's subsidiary or affiliate in an effort to improve the condition of the company and thus the marketability of the company's securities. The May 1983 proposal would have prohibited a bank from: (1) Making extensions of credit to any company whose securities are currently underwritten or distributed by the bank's subsidiary or affiliate unless those securities are rated in the top four rating categories by a national recognized rating service, (2) making any extension of credit to a money market fund currently underwritten or distributed by the bank's subsidiary of affiliate, (3) making any extension of credit where the proceeds are to be used to acquire securities currently underwritten or distributed by the bank's subsidiary or affiliate, (4) accepting securities currently underwritten or distributed by the bank's subsidiary or affiliate as collateral on an extension of credit, (5) making any extension of credit to its securities subsidiary or affiliate that does not comport with the restrictions contained in section 23A of the Federal Reserve Act, and (6) making any extension of credit to any investment company advised by the bank's subsidiary or affiliate

if the extension of credit does not comport with section 23A of the Federal Reserve Act.

The proposed regulation makes a number of changes to this portion of May 1983 proposal. The prohibition on a bank lending to companies whose nonrated securities are underwritten or distributed by the bank's subsidiary found in the May 1983 proposal has not been retained. AS the proposed regulation does not permit the bank's subsidiary to underwrite securities unless the securities are of investment quality, the restriction as it was earlier proposed is no longer necessary; *i.e.*, the concern that the bank may make imprudent loans to companies whose low quality securities are being underwritten by the bank's subsidiary in order to improve the marketability of the companies' securities is no longer present. The restriction found in the May 1983 proposal on extensions of credit to companies whose low quality securities are underwritten or distributed by the bank's affiliate has been retained, however, as the proposed regulation does not contain a similar requirement that the bank's affiliate solely underwrite investment quality securities. Thus, under the proposed regulation, a bank cannot make any extensions of credit to a company whose securities are currently underwritten or distributed by the bank's affiliate if those are not of investment quality.

Five comments received in response to the May, 1983 proposal expressed the opinion that the lending restriction as it was then proposed would serve only to constrict credit sources for smaller firms whose securities are not rated by a nationally recognized rating service. The proposed revisions of the definition of investment quality debt security to include unrated debt obligations of comparable quality to highly rated debt obligations is an effort to be responsive to these comments. (See discussion in paragraph 3.) FDIC does not feel that the broadened definition will reduce the effectiveness of the lending restriction as the unrated debt securities must still be high quality in order for the company to be eligible for loans from the bank. The proposed regulation will

still prohibit the bank from making extensions of credit to companies whose unrated and/or poorly rated equity securities are underwritten or distributed by the bank's affiliate.

In response to a comment to the May, 1983 proposal, a footnote has been added to the proposed regulation indicating that the paragraph (e)(3) is not to be construed to prohibit the bank from honoring a loan commitment or revolving loan agreement, or funding a line of credit, where such were entered into prior in time to the underwriting or distribution. Finally, all of the restrictions contained in subsection (e) that use the phrase "any security *currently* being distributed or underwritten" [emphasis added] have been footnoted in response to several comments in response to the May, 1983 proposal requesting that the relevant time period be more clearly defined. The footnote provides that in complying with the provisions of the proposed regulation which reference a current distribution or current underwriting, the bank may rely upon the affiliate's or subsidiary's statement that the underwriting or distribution of any particular security has terminated.

The proposed regulation retains the prohibition found in the May, 1983 proposal on a bank making any extension of credit or loan directly or indirectly to any money market fund or mutual fund whose shares are currently being underwritten or distributed by a subsidiary or affiliate of the bank. For purposes of clarity, both restrictions are expressly set forth in paragraph (e)(4) of the proposed regulation. As stated in the preamble to the May, 1983 proposal, FDIC considered exempting mutual funds and money market funds from the reach of the lending restriction. Such an exemption was rejected, however, inasmuch as the credit needs of such funds are most likely to arise when the fund is having liquidity problems. If interest rates should rise sharply and large numbers of shareholders, especially institutional investors, redeem their shares to put their money directly into higher paying investments, a fund could face a liquidity crisis. A bank may thus be tempted to make an unsound loan to the fund in order to prevent the fund from suffering a loss by selling portfolio

assets at a depressed price to meet liquidity needs. As the FDIC received no comments critical of the restriction, and it is still our opinion that the restriction is warranted, it has been retained in the proposed regulation. Money market funds have been targeted within that prohibition despite their relative stability as at present there is no self-regulatory organization such as the National Association of Securities Dealers ("NASD") to watchdog money market funds.

The May, 1983 proposal contained a prohibition on a bank accepting as collateral on a loan or extension of credit securities of any company whose securities are currently being distributed or underwritten by the bank's subsidiary or affiliate or accepting as collateral any shares currently being distributed or underwritten by an investment company advised by the bank's subsidiary or affiliate. The proposed regulation has deleted the restriction on the acceptance of collateral in response to several comments which indicated that there was no need to impose such a restriction if the loan was in no way connected with the underwriting or the distribution.

The proposed regulation retains the restriction on a bank extending credit for the purpose of acquiring securities currently being underwritten or distributed by the bank's subsidiary or affiliate, securities issued by an investment company advised by a bank's subsidiary or affiliate, or securities issued by the bank's subsidiary or affiliate. The proposed restriction contains a new exception, however, that would permit the bank to extend credit to any employees of the subsidiary or affiliate where the purpose of the loan is to acquire securities of the subsidiary or affiliate through an employee stock bonus or stock purchase plan adopted by the board of directors or board of trustees of the subsidiary or affiliate. This exception, and a footnote indicating that the bank may rely in good faith on the customer's statement as to the purpose of the loan, are being proposed in response to several comments in response to the May, 1983 proposal.

The wording of the purpose lending restriction has been slightly modified in the proposed regulation. It now refers to securities

issued by an investment company advised by the bank's subsidiary or affiliate. The reference to securities "underwritten or distributed" by an investment company has been deleted. A comment in response to the May, 1983 proposal pointed out that investment companies normally do not underwrite or distribute their own securities and that therefore the references in the May, 1983 proposal to securities underwritten or distributed by an investment company were inaccurate. Corresponding changes have been made in other portions of the proposed regulation which refer to investment companies advised by the bank's subsidiary or affiliate.

The proposed regulation retains the provision found in the May, 1983 proposal that subjects extensions of credit to the bank's subsidiary to the same loan ceiling and other restrictions as would be applicable under section 23A of the Federal Reserve Act if the subsidiary were an affiliate for the purposes of that statute. The proposed regulation also retains the restriction which subjects extensions of credit to an investment company advised by a bank's subsidiary to the same loan ceiling and other restrictions that would be applicable under section 23A of the Federal Reserve if the subsidiary were an affiliate within the meaning of section 23A. As loans or extensions of credit to the bank's affiliate as that term is defined in the proposed regulation are already covered by the language of section 23A, placing affiliates under the restrictions of paragraph (e)(6) will not establish any additional requirements. Additionally, as section 23A covers extension of credit to investment companies advised by the bank's affiliates, placing affiliates under the restriction of paragraph (e)(7) will not establish any additional requirements. In response to comments on these two provisions received in response the exemptions contained in section 23A as well as the restrictions. Additionally, paragraph (e)(6) has been clarified to indicate that it does not operate to modify the investment restriction contained in paragraph (b)(2) of the proposed regulation. (See discussion in paragraph 7 below.)

6. Trust Department Restrictions

The May, 1983 proposal contained a provision that would have prohibited an insured nonmember bank which as a subsidiary or affiliate that engages in the sale, distribution or underwriting of stocks, bonds, debentures, notes or other securities or acts as an investment adviser to any investment company that sells, distributes, or underwrites any such security from purchasing in its sole discretion as fiduciary or co-fiduciary any security currently being issued, distributed, or underwritten by that subsidiary or affiliate or purchasing in its sole discretion any security currently being distributed, underwritten, or issued by any investment company advised by the subsidiary or affiliate. The May, 1983 proposal also would have prohibited an insured nonmember bank for transacting business through its trust department with its securities subsidiary of affiliate unless the transactions are comparable to transactions with an unaffiliated securities company or a securities company that is not a subsidiary of the bank.

The FDIC received relatively few comments regarding these two proposed restrictions, the first of which was designed to curtail the dumping of poor issues into the trust department. Two comments indicated that the restrictions, were unnecessary as they were simply a restatement of common law. One comment indicated that the proposal was too restrictive. One comment indicated that the proposed restrictions were satisfactory. Three comments, including that of SEC Commissioner Shad, suggested that the trust department should be entirely prohibited from dealing with its securities subsidiary or affiliate. One comment suggested that the phrase "in its sole discretion" be clarified.

The proposed regulation permits insured nonmember banks to purchase, as fiduciary, securities currently distributed, underwritten or issued by the bank's subsidiary or affiliate or currently issued by an investment company advised by the bank's subsidiary or affiliate where those purchases are expressly authorized by the trust instrument, court order, or local law, or specific authority for the purchase is obtained from all interested parties after

full disclosure. The language change adds clarity to the provision and is, at the same time, consistent with the common law obligation of a fiduciary to refrain from self dealing in the administration of a trust account. It is also consistent with statements regarding trust department examinations found in FDIC's Manual of Examination Policies. The FDIC is preliminary rejecting as overly broad the suggestion that the trust department by prohibited entirely from dealing with the bank's securities subsidiary or affiliate. We recognize the possibility for some abuses and the potential for conflicts of interest in the administration of trust accounts, however, we are presently of the opinion that the restriction contained in the proposed regulation should adequately protect against such abuses and conflicts of interest.

The proposed regulation retains the provision found in the May, 1983 proposal indicating that the bank shall not transact business through it's trust department with its securities subsidiary or affiliate unless the transactions are comparable to transactions with unaffiliated securities companies or a securities company that is not a subsidiary of the bank. This requirement will help to insulate the bank from the possibility that its securities affiliate will drain off profits from the bank by setting a higher than normal fee for executing transactions. The proposed regulation will not prohibit a bank trust department from using the broker/dealer services of its subsidiary or affiliate to execute transactions on behalf of its fiduciary accounts. The decision to utilize the related broker/dealer must, however, fully comport with the bank's fiduciary obligation to its trust department customer and must be fully disclosed.

7. Investment Ceiling

The proposed regulation restricts an insured nonmember bank's direct and indirect investment in one or more securities subsidiaries to 20% of the bank's equity capital unless the FDIC approves a greater investment. This provision is essentially the same as was proposed for comment in May, 1983; *i.e.* the 20% of equity capital test has been retained with one change. The term

investment has been clarified by the addition of the phrase "direct and indirect." The proposed regulation thus places a limit on a bank's subsequent extensions of credit to its subsidiary. The total figure cannot exceed 20% of the bank's equity capital. The limit is subject, however, to any lesser investment cap established by State law.

While none of the comments addressing the proposed investment limitation as contained in the May, 1983 proposal criticized restricting a nonmember bank's investment in a securities company, several expressed the view that a 20% ceiling was high. The 20% ceiling has been retained in the proposed regulation, however, as the limitation covers direct investments as well as subsequent extensions of credit. The provisions operates in tandem with paragraph (e)(6) which requires that extensions of credit by an insured nonmember bank to its securities subsidiary conform to the requirements as to amount, collateral, etc. found in section 23A of the Federal Reserve Act. If, for example, the bank's direct investment in its subsidiary equals 10% of the bank's equity capital, the bank may make an additional indirect investment in the subsidiary by way of one or more extensions of credit not exceeding in the aggregate an additional 10% of the banks equity capital. If, however, the bank's direct investment equals 5% of the bank's equity capital, paragraph (e)(6) would still restrict the bank's subsequent permissable extensions of credit to 10% of the bank's equity capital as section 23A of the Federal Reserve Act establishes a lending cap of 10%. Furthermore, the bank's direct investment in the subsidiary may range up to 20% of the bank's equity capital. If such were the case, however, the bank could not make any extensions of credit to the subsidiary under paragraph (e)(6).

The investment limitation in the proposed regulation is designed to create a buffer between the operation of a bank's subsidiary (or subsidiaries) and the bank in addition to the buffer provided by the subsidiary's capital position. Although the FDIC will have the authority under section 10 of the FDI Act (12 U.S.C. 1820) to examine the affairs of the securities subsidiaries

or affiliates as shall be necessary to disclose fully the relations between the bank and those subsidiaries or affiliates and the effect of such relations upon the bank, the FDIC does not actually "supervise" the subsidiaries or affiliates. It will be difficult for the FDIC to accurately judge the adequacy of a subsidiary's capital from a safety and soundness point of view on a daily basis, especially as factual cricumstances may vary. The FDIC has therefore determined that the possibility of adverse impact to the bank should the subsidiary fail or suffer extreme loss is appropriately limited by placing a ceiling on the bank's investment in the subsidiary.

As reflected in what is now a footnote to paragraph (b)(2), the bank's direct investment in the securities subsidiary will not be counted toward the bank's regulatory capital. This provides the FDIC with an enforcement tool to help safeguard the bank's safety and soundness. If, for example, the FDIC should determine after receiving notice under subsection (d) that an insured nonmember bank's equity capital is not adequate after making the necessary adjustments indicated in footnote 5, the bank would not be able to proceed with the acquisition or establishment of the subsidiary.

8. Affiliation With a Securities Company

The proposed regulation prohibits an insured nonmember bank from becoming affiliated with a securities company unless: (1) The securities business of the affiliate is physically separate in its operation from the operation of the bank and does not operate on the same floor of a building on which the bank receives deposits; (2) the bank does not share common officers with the affiliate; (3) a majority of the board of directors of the bank is composed of persons who are neither directors nor officers of the affiliate; (4) any employee of the affiliate who is also an employee of the bank does not conduct any securities activities on behalf of the affiliate on the premises of the bank that involve customer contact; (5) the bank and affiliate do not share a common name or logo; and (6) the affiliate conducts business pursuant to policies

and procedures independent from the bank so that customers of the affiliate are aware that the affiliate is a separate organization from the bank and that investments recommended, offered or sold by the affiliate are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

The May, 1983 proposal only required that the securities business of the bank's affiliate be "kept separate and distinct from the banking business of the insured nonmember bank". The FDIC did not necessarily mean to imply that the affiliate could more closely mingle its operations with the bank than could the bank mingle operations with its subsidiary. The FDIC is therefore specifically proposing restrictions that parallel those set forth for subsidiaries. The FDIC feels that the restrictions are as warranted in the case of an affiliate as in the case of a subsidiary. The restrictions would appear necessary in order to avoid customer confusion, to avoid conflicts of interest, to avoid a finding that the bank is itself engaged in prohibited securities activities, and to avoid a finding that the affiliated securities company is taking deposits in violation of section 21 of the Glass-Steagall Act. If the FDIC approves deposit insurance for a newly chartered bank whose parent is a securities company and the bank is so closely intertwined with its parent that one could find the parent securities company is taking deposits, the FDIC would, by its action, countenance a violation of Glass-Steagall Act. The FDIC is specifically interested in receiving comment on the necessity of these restrictions and is especially interested in receiving comment addressing the problems, ramifications, burdens, etc. that might be associated with the director/officer restrictions and prohibition on the use of common names or logos.

9. Tying

The proposed regulation contains a prohibition on an insured nonmember bank either directly or indirectly conditioning an extension of credit to any company on the requirement that the

company contract, or agree to contract, with the bank's subsidiary or affiliate to underwrite or distribute that company's securities. The provision also prohibits a bank from conditioning an extension of credit to any person on the requirement that that person purchase any security currently underwritten or distributed by the bank's subsidiary or affiliate. Although insured nonmember banks that are part of a bank holding company system are subject to similar anti-tying restrictions under the Bank Holding Company Act Amendments of 1970, that Act would not seem to cover banks that are not held by bank holding companies in that the restrictions cover the tying of a loan with some additional credit, property, or service from the bank, the bank's holding company, or any other subsidiary of the bank's holding company. (12 U.S.C. 1972). The restriction in the proposed regulation fills that gap and serves as a reminder to all insured nonmember banks not to engage in unlawful tying practices. As a large number of insured nonmember banks are held by bank holding companies, the imposition of this requirement would not represent a major change from the status quo.

10. Construction of the Terms "Underwrite", "Distribute", and "Security"

It is not FDIC's intent by proposing this regulation to prevent an insured nonmember bank subsidiary from engaging in any securities underwriting activity that the insured nonmember bank may itself lawfully pursue under the Glass-Steagall Act. Those activities are set forth in 12 U.S.C. 24 (Seventh) and include underwriting obligations of the United States, general obligations of any state or political subdivision thereof, and numerous other obligations specifically named therein. Insured nonmember banks should keep in mind that the terms "underwrite" and "distribute", and the phrase "stocks, bonds, debentures, notes, or other securities" are to be construed consistently with the securities laws and regulations except where the context requires otherwise. A securities subsidiary or affiliate of an insured

nonmember bank while engaged in the conduct of securities activities will be subject to the securities laws and regulations, the oversight of the SEC, and oversight by entities such as the NASD. The above terms are therefore to have the meaning proscribed by the securities laws and regulations when used in connection with the subsidiary of affiliate. References in the proposed regulation to these terms as used in conjunction with an insured nonmember bank (see subparagraph (b)(1)(i), and subsections (f) and (g)) are to be construed consistently with the Glass-Steagall Act.

The courts have repeatedly stated that the prohibitions of the Glass-Steagall Act are to be defined with reference to the purposes of that statute and that the definitions of the terms used therein (*i.e.*; distribute, underwrite, security) do not necessarily coincide with the definition of the same terms as used in the securities laws. (See *A.G. Becker, Inc.* v. *Board of Governors of the Federal Reserve System*, 693 F.2d 136 (D.C. Cir. 1982) *cert. granted*, 52 U.S.L.W. 3262 (October 4, 1983); *National Association of Securities Dealers Inc.* v. *Securities and Exchange Commission*, 420 F.2d 83 (D.C. Cir. 1969); *New York Stock Exchange, Inc.* v. *Smith*, 404 F. Supp. 1091 (D.D.C. 1975), *vacated on other grounds*, 562 F.2d 736 (D.C. Cir. 1977)). The FDIC therefore intends to utilize a functional analysis in determining whether a particular activity constitutes underwriting or distributing of a security under the Glass-Steagall Act.

11. Definition of "Affiliate", "Subsidiary", and "Extension of Credit"

The proposed regulation defines the term "affiliate" essentially as found in the May, 1983 proposal; *i.e.*, to mean a company that directly or indirectly controls an insured nonmember bank and any company that is in turn controlled by such a company. The proposed regulation has expanded the definition of affiliate, however, from that found in the May, 1983 proposal to cover a company controlled by a person or group of persons that controls an insured nonmember bank. "Control" is defined as the power

to directly or indirectly vote 25 percent of a bank's or company's stock, the ability to control the election of a majority of a bank's or company's directors or trustees, or the ability to exercise a controlling influence over the management and policies of a bank or company. Again, this definition has not changed from the May, 1983 proposal. At a minimum, the proposed regulation treats as affiliates of the bank a bank's parent company, a company that controls 25 percent or more of the bank's stock, and companies controlled by either of the above.

The term "subsidiary" is defined in the proposed regulation to mean a company controlled by a bank. The remainder of the definition as proposed in May, 1983 which would have included as a subsidiary any company a majority of whose directors or trustees are directors or trustees of an insured nonmember bank has been deleted. This language has been dropped inasmuch as the term "bona fide subsidiary" as contained in the proposed regulation prohibits the bank's subsidiary from sharing a majority of its directors and officers with the bank if the subsidiary conducts securities activities that the bank could not itself conduct. As "company" is defined in the proposed regulation to include corporations other than banks, partnerships, business trusts, associations, joint ventures, pool syndicates or other similar business organizations, a securities company operated by several banks in a cooperative effort can be considered a subsidiary of each of the banks. Although it is possible for a mutual fund (*i.e.;* a business trust) to be a subsidiary of the bank if controlled by the bank, we anticipate that this will not generally be the case. The term "extension of credit" has generally the same meaning as found in Federal Reserve Board Regulation O (12 CFR 215.3) which concerns insider transactions. The term as defined herein, however, covers purchases "whether or not under repurchase agreement" of securities, other assets, or obligations. The "whether or not" language has been included in the proposed regulation in an attempt to control the extent to which a bank may indirectly pour money into the subsidiary by means of purchasing securities and other assets from the subsidiary. Lastly, the May, 1983 proposal

covered the "grant" of a line of credit as an extension of credit whereas the proposed regulation covers a "draw" upon a line of credit as an extension of credit rather than simply the grant.

12. "Phase Out" Provision

The proposed regulation requires all insured nonmember banks that established or acquired securities subsidiaries prior to the effective date of the regulation or which became affiliated with securities companies prior to the effective date of the regulation to bring themselves into compliance with the regulation within two years. Any bank that established or acquired a securities subsidiary prior to the relevant date must, however, comply with § 337.4(b)(1)(ii) and §§ 337.4(c) and 337.4(e) as soon as practicable. Section 337.4(b)(1)(ii) requires that the subsidiary be a bona fide subsidiary if it conducts activities not permitted to the bank under the Glass-Steagall Act. § 337.4(c) pertains to affiliations with securities companies, and § 337.4(e) places lending and other restrictions on the bank. The proposed regulation also requires that any insured nonmember bank that is subject to the phase-out provisions established by the regulation must inform the FDIC in writing within thirty days from the effective date of the regulation that it has a subsidiary or affiliate that conducts securities activities. This notice will provide FDIC with a mechanism to monitor compliances with the phase out requirement. The FDIC is specifically requesting comment addressing two issues: (1) Is immediate compliance more appropriate than a phase out provision in view of FDIC's stance that the restricted activities may pose a safety or soundness problem, and (2) if a phase out provision is adopted, should it be longer that two years or shorter.

13. Section 337.4(f) and 337.4(g)

These sections of the proposed regulation are being reproposed without change. They serve to remind insured nonmember banks that (1) it is not FDIC's intent to prohibit a bank subsidiary from

conducting any securities activity that the bank itself could lawfully conduct under the Glass-Steagall Act, and (2) that the regulation does not authorize the bank to itself conduct any securities that are not lawful uner the Glass-Steagall Act. We wish to stress that the proposed regulation does *not* authorize any insured nonmember bank to either directly, or indirectly through a subsidiary, conduct any securities activity. An insured nonmember bank must derive that authority, if at all, from some other source, such as state law.

14. Paperwork Reduction Act

The notice requirements contained in the proposed regulation do not constitute "collections of information" for purposes of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*) and therefore are not subject to the Office of Management and Budget ("OMB") clearance provisions of that Act. This is because the notice requirements fall within the exception to the definition of "information" set out in § 1320.7(k)(1) of OMB regulations implementing the "collection of information clearance" provisions of the Act (5 CFR Part 1320). It is recognized, however, that the notice requirements do place an affirmative obligation on a bank to notify the FDIC of its intended action and to confirm whether or not a subsidiary was acquired or established. Any costs associated with these notices could appear, however, to be minimal. The proposed regulation does not specify the content of the written notices nor require the bank to provide any specific information. Inasmuch as the bank subsidiary will in all likelihood be filing with the SEC, no additional paperwork burdens of any kind should be created.

15. Regulatory Flexibility Analysis

In accordance with FDIC's policy statement entitled "Development and Review of FDIC Rules and Regulations" and the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), the FDIC conducted an analysis of the impact of the proposed regulation. The results of that analysis follow.

In general, participation by bank subsidiaries in the underwriting market for new securities issues offers a number of potential benefits. Bank participation will likely lower underwriting costs for issuers in a number of markets. This competitive benefit should be particularly noticeable in local and regional markets where the number of bidders for a new issue is generally small.

Additionally, increased activity in the secondary market for securities will increase the liquidity of any new issue. This will increase the attractiveness of new securities issues to potential investors. The presence of new entrants in the underwriting and discount brokerage markets should increase investor awareness, provide for greater customer convenience and lower brokerage costs to investors (both for users of discount brokerage and full service brokerage services) as fee and service competition increases.

All of the above factors will tend to benefit the U.S. economy as more money flows into the capital markets.

The proposed regulation should not interfere substantially with the realization of these potential benefits. Moreover, it should provide additional benefits in that it reduces the potential for conflicts of interest, helps ensure that banks are adequately insulated from their subsidiaries, and prevents these subsidiaries from engaging in excessive risk taking. Furthermore, the proposed regulation should not, in any way, give certain competitors unfair advantage of work to the detriment of small banks.

There would be an overall cost to the economy if the advent of bank securities subsidiaries could be expected to jeopardize the viability of the nation's banking institutions. That does not appear to be the case, however, and certainly is not the case when the structure of the proposed regulation is taken into consideration. For example, the proposal is structured so as to insulate the bank from the activities of the subsidiary as well as any financial repercussions generated by losses on the part of the subsidiary. The subsidiary will only be able to underwrite top-rated securities or underwrite shares in money market funds which are recognized as relatively sound investments. Thus, there is less of a likelihood

that the subsidiary will incur losses that it could not safely absorb. The bank is further insulated as it will not be able to make purpose loans, prop up companies whose securities are underwritten by the bank's subsidiary or affiliate, make excessive loans to its securities subsidiary or affiliate, invest an excessive amount of capital in the subsidiary, or move poor issues into the bank's trust department.

Several provisions of the proposed regulation are designed to address the potential for conflicts of interest. It should be pointed out, however, that conflicts of interest can never be entirely eliminated. Nor would it be desirable to attempt to do so as the costs associated with excessive restrictions and government oversight would far outweigh the potential benefits from any incremental reduction in conflicts of interest.

The proposed regulation should not be detrimental to small banks. Setting the investment cap in the subsidiary at 20 percent of equity capital should enable even relatively small insured nonmember banks to indirectly compete in the securities market through a subsidiary. Moreover, there are no restrictions against joint ventures, *i.e.*, more than one bank or financial institution can join together to form a securities subsidiary. The requirements that the securities business of the affiliate by physically distinct in its operation from the operation of the bank and that a majority of the bank's officers and directors not be officers or directors of the affiliate should not be an excessive burden on small banks.

Lastly, the proposed regulation may duplicate, overlap, or conflict with existing Federal laws and regulations governing the establishment and operation of securities companies, section 23A of the Federal Reserve Act (12 U.S.C. 371c), the Bank Service Corporation Act, as amended by the Garn-St Germain Depository Institutions Act (12 U.S.C. 1861 *et seq.*), and the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*).

List of Subjects in 12 CFR Part 337

Bank, bankings, Securities, State nonmember banks.

In consideration of the foregoing, the FDIC hereby proposes to amend Part 337 of title 12 of the *Code of Federal Regulations* as follows:

PART 337—UNSAFE AND UNSOUND BANKING PRACTICES

1. The authority citation for Part 337 is revised to read as follows:

> Authority: Sec. 6, 64 Stat. 876, 12 U.S.C. 1816; sec. 8(b), section 2[8(b)] of the Act of September 21, 1950 (Pub. L. 797), as added by sec. 202 of title II of the Act of October 16, 1966 (Pub. L. 89-695; 80 Stat. 1046), as amended by section 110 of title I of the Act of October 28, 1974 (Pub. L. 93-495; 88 Stat. 1506); sec. 11 of the Act of September 17, 1978 (Pub. L. 95-369; 92 Stat. 624); sec. 107(a)(1) and 107(b) of title I of the Act of November 10, 1978 (Pub. L. 95-630; 92 Stat. 3649 and 3653); and secs. 404(c), 425(b), and 425(c)of title IV of the Act of October 15, 1982 (Pub. L. 97-320; 96 Stat. 1512 and 1524); 12 U.S.C. 1818(b); sec. 9, 64 Stat. 881-882, 12 U.S.C. 1819; sec. 18(j)(2); 92 Stat. 3664, 12 U.S.C. 1828(j)(2), sec. 422, 96 Stat. 1469, (Pub. L. 97-320).

2. It is proposed that Part 337 be amended by adding new § 337.4 to read as follows:

§ 337.4 Securities Activities of Subsidiaries of Insured Nonmember Banks: Bank Transactions with Affiliated Securities Companies.

(a) *Definitions:* for the purposes of this section,

(1) "Affiliate" shall mean any company that directly or indirectly, through one or more intermediaries, controls an insured nonmember bank, and shall include any company controlled by a company, person, or group of persons that controls an insured nonmember bank.

(2) "Bona fide subsidiary" means a subsidiary of an insured nonmember bank that at a minimum (i) is adequately capitalized; (ii) is physically separate in its operations from the operation of the of the bank and does not operate on the same floor of a building on which deposits are received; (iii) does not share a common name or logo with the bank; (iv) maintains separate accounting and other corporate records; (v) observes separate formalities such as separate board of directors' meetings; (vi) maintains separate employees who are compensated by the subsidiary;[1] (vii) shares no common officers with the bank; (viii) a majority of its board of directors is composed of persons who are neither directors nor officers of the bank; and (ix) conducts business pursuant to policies and procedures independent from the bank so that customers of the subsidiary are aware that the subsidiary is a separate organization from the bank and that investments recommended, offered or sold by the subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

(3) "Company" shall mean any corporation (other than a bank), any partnership, business trust, association, joint venture, pool syndicate, or other similar business organization.

(4) "Control" shall mean the power to directly or indirectly vote 25 per centum or more of the voting stock of a bank or company, the ability to control in any manner the election of a majority of a bank's or company's directors or trustees, or the ability to exercise a controlling influences over the management and policies of a bank or company.

(5) "Extension of credit" shall mean the making or renewal of any loan, a draw upon a line of credit, or an extending of credit in any manner whatsoever and includes, but is not limited to:

(i) A purchase, whether or not under repurchase agreement, of securities, other assets, or obligations;

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1. This requirement shall not be construed to prohibit the use by the subsidiary of bank employees to perform functions which do not relate to customer contact such as accounting, data processing and recordkeeping, so long as the bank and the subsidiary contract for such services on terms and conditions comparable to those agreed to by independent entities.

(ii) An advance by means of an overdraft, cash item, or otherwise;

(iii) Issuance of a standby letter of credit (or other similar arrangement regardless of name or description);

(iv) An acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which a natural person or company may be liable as maker, drawer, endorser, guarantor, or surety;

(v) A discount of promisory notes, bills of exchange, conditional sales contracts, or similar paper, whether with or without recourse;

(vi) An increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for (A) accrued interest or (B) taxes, insurance, or other expenses incidental to the existing indebtedness; or

(vii) Any other transaction as a result of which a natural person or company becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.

(6) "Investment quality debt security" shall mean a marketable obligation in the form of a bond, note, or debenture that is rated in the top four rating categories by a nationally recognized rating service or a marketable obligation in the form of a bond, note, or debenture the investment characteristics of which are equivalent to the investment characteristics of such a top-rated obligation.

(7) "Investment quality equity security" shall mean marketable common or preferred corporate stock that is rated medium grade, average or better by a nationally recognized rating service.

(8) "Subsidiary" shall mean any company controlled by an insured nonmember bank.

(b) *Investment in securities subsidiaries.* (1) An insured nonmember bank may not establish or acquire a subsidiary that engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes or other securities; conducts any activities for

which the subsidiary is required to register with the Securities and Exchange Commission as a broker/dealer; acts as an investment adviser to any investment company; or engages in any other securities activity unless:

(i) The subsidiary's underwriting activities that would not be authorized to the bank under section 16 of the Glass-Steagall Act (12 U.S.C. 24 (Seventh)) as made applicable to insured nonmember banks by section 21 of the Glass-Steagall Act (12 U.S.C. 378) are limited to, and thereafter continue to be limited to, one or more of the following: (A) Underwriting of investment quality debt securities; (B) underwriting of investment quality equity securities; (C) underwriting of nutual funds whose investments are exclusively limited to investment quality debt securities and/or investment quality equity securities; or (D) underwriting of nutual funds whose investments are exclusively limited to obligations of the United States or United States Government agencies, repurchase agreements involving such obligations, bank certificates of deposit, banker's acceptances and other bank money instruments, short-term corporate debt instruments, short-term corporate debt instruments and other similar investments normally associated with a money market fund; and

(ii) the subsidiary is, and thereafter continues to be, a bona fide subsidiary if that subsidiary conducts securities activities not authorized to the bank under section 16 of the Glass-Steagall Act as made applicable to insured nonmember banks by section 21 of the Glass-Steagall Act.

(2) An insured nonmember bank's direct and indirect investment in one or more subsidiaries under subparagraph (b)(1) shall not exceed in the aggregate 20 per centum of the bank's equity capital as defined by FDIC for capital adequacy purposes unless prior approval for a greater investment is obtained from the FDIC.[2]

(c) *Affiliation with a securities company.* An insured nonmember bank is prohibited from becoming affiliated with any

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2. An insured nonmember bank's direct investment in a securities subsidiary will not be counted toward the bank's regulatory capital.

company that directly or indirectly engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities; acts as an investment adviser to any investment company; conducts any activity for which the affiliate must register with the Securities and Exchange Commission as a broker/dealer; or engages in any other securities activity unless: (1) the securities business of the affiliate is physically separate in its operation from the operation of the bank and does not operate on the same floor of a building on which the bank receives deposits; (2) the bank and affiliate share no common officers; (3) a majority of the board of directors of the bank is composed of persons who are neither directors nor officers of the affiliate; (4) any employee of the affiliate who is also an employee of the bank does not conduct any securities activities on behalf of the affiliate on the premises of the bank that involve customer contact; (5) the bank and affiliate do not share a common name or logo; and (6) the affiliate conducts business pursuant to policies and procedures independent from the bank so that customers of the affiliate are aware that the affiliate is a separate organization from the bank and that investments recommended, offered or sold by the affiliate are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

(d) *Filing of notice.* Every insured nonmember bank that intends to acquire or establish a subsidiary that: (1) engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities; (2) acts as an investment advisor to any investment company; (3) conducts any activity for which the subsidiary is required to register with the Securities and Exchange Commission as broker/dealer; or (4) engages in any other securities activity, shall notify the regional director of the FDIC region in which the bank is located of such intent. Notice shall be in writing and must be received in the regional office at least 60 days prior to consummation of the acquisition or commencement of the operation of the subsidiary, whichever is earlier. The bank shall also notify the regional office in writing within 10 days after the consummation of the acquisition or

commencement of the operation of the subsidiary, whichever is earlier. The 60-day notice requirement may be waived in FDIC's discretion where such notice is impracticable such as in the case of a purchase and assumption transaction or an emergency merger. Where the above notices pertain solely to the transfer of securities activities previously performed by the bank to the subsidiary, an additional written notice must be filed with the regional office if the subsidiary commences any securities activity covered by paragraph (b)(1)(i) of this section. This notice must be received in the regional office within thirty days after the subsidiary commences the new activity.

(e) *Restrictions.* An insured nonmember bank which has a subsidiary or affiliate that engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities, or acts as an investment adviser to any investment company shall not:

(1) Purchase as fiduciary or co-fiduciary any security currently distributed, currently underwritten, or issued by such subsidiary or affiliate or purchase as fiduciary or co-fiduciary any security currently issued by an investment company advised by such subsidiary or affiliate, unless the purchase is expressly authorized by the trust instrument, court order, or local law, or specific authority for the purchase is obtained from all interested parties after full disclosure;

(2) Transact business through its trust department with such subsidiary or affiliate unless the transactions are at least comparable to transactions with an unaffiliated securities company or a securities company that is not a subsidiary of the bank;

(3) Extend credit or make any loan directly or indirectly to any company the stocks, bonds, debentures, notes or other securities of which are currently are underwritten or distributed by an

affiliate of the bank unless the company's stocks, bonds, debentures, notes or other securities that are underwritten or distributed (i) qualify as investment quality debt securities, or (ii) qualify as investment quality equity securities;[3]

(4) Extend credit or make any loan directly or indirectly to any money market fund or mutual fund whose shares are currently underwritten or distributed by a subsidiary or affiliate of the bank;

(5) Extend credit or make any loan where the purpose of the extension of credit or loan is to acquire (i) any stock, bond, debenture, note, or other security currently underwritten or distributed by such subsidiary or affiliate; (ii) any security currently issued by an investment company advised by such subsidiary or affiliate; or (iii) any stock, bond, debenture, note, or other issued by such subsidiary or affiliate, except that a bank may extend credit or make a loan to employees of the subsidiary or affiliate for the purpose of acquiring securities of such subsidiary or affiliate through an employee stock bonus or stock purchase plan adopted by the board of directors or board trustees of the subsidiary or affiliate;[4]

(6) Make any loan or extension of credit to a subsidiary or affiliate of the bank that (i) distributes or underwrites stocks, bonds, debentures, notes, or other securities, or (ii) advises any investment company, if such loans or extensions of credit would be in excess of the limit as to amount, and not in accordance with the restrictions as to collateral, etc., imposed on "covered transactions" by section 23A of the Federal Reserve Act (12 U.S.C. 371c) and that are not within any exemptions established thereby; however, nothing herein shall be construed as limiting the amount of a bank's direct investment in such subsidiary other than as set out in paragraph (b)(2) of this section;

3. This restriction shall not be construed to prohibit the bank from honoring a loan commitment or revolving loan agreement or funding a line of credit where the loan commitment, revolving loan agreement, or line of credit was entered into prior in time to the underwriting or distribution.

4. In complying with § 337.4(e)(5) of this part, the bank shall be entitled to rely in good faith on the customer's statement as to the purpose of the extension of credit or loan.

(7) Make any loan or extension of credit to any investment company for which the bank's subsidiary or affiliate acts as an investment adviser if the loan or extension of credit would be in excess of the limit as to amount, and not in accordance with the restrictions as to collateral, etc; imposed on "covered transactions" by section 23A of the Federal Reserve Act and that are not within any exemptions established thereby; and

(8) Directly or indirectly condition any loan or extension of credit to any company on the requirement that the company contract with, or agree to contract with, the bank's subsidiary or affiliate to underwrite or distribute the company's securities or directly or indirectly condition any loan or extension of credit to any person on the requirement that that person purchase any security currently underwritten or distributed by the bank's subsidiary or affiliate.[5]

(f) Nothing in this section prohibits an insured nonmember bank from establishing or acquiring a subsidiary that sells, distributes, or underwrites stocks, bonds, debentures, notes, or other securities or engages in any other securities activity if those activities would be permitted to an insured nonmember bank by sections 16 and 21 of the Glass-Steagall Act (12 U.S.C. section 24 (Seventh) and 378).

(g) Nothing in this section authorizes an insured nonmember bank to directly engage in any securities activity not authorized to it under sections 16 and 21 of the Glass-Steagall Act (12 U.S.C. section 24 (Seventh) and 378).

(h) An insured nonmember bank that prior to [insert effective date of regulation] became affiliated with a securities company or prior to that date established or acquired a subsidiary that engages in securities activities, shall have two years from [insert effective date of regulation] to bring itself into compliance with § 337.4 of this part, except that, such bank must comply with paragraphs (b)(1)(ii), (c) and (e) of this section as soon as

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5. An insured nonmember bank in complying with the requirements of § 337.4(e)(1), (e)(3), and (e)(4) of this part concerning "current" underwritings and distributions may rely upon the affiliate's or subsidiary's statement that the underwriting or distribution of any particular security has terminated.

practicable and must inform the regional director of the FDIC region in which the bank is located not later than 30 days after [the effective date of the regulation] that the bank is affiliated with a company that engages in securities activities or has a subsidiary that engages in securities activities.

By order of the Board of Directors, 23rd day of April, 1984.

Federal Deposit Insurance Corporation.

Hoyle L. Robinson,
Executive Secretary
[FR Doc. 84-11886 Filed 4-30-84; 8:45 a.m.]

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Federal Register/Vol. 48, No. 96/Tuesday, May 17, 1983
Proposed Rules 22,155

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 337

Unsafe and Unsound Banking Practices

AGENCY: Federal Deposit Insurance Corporation ("FDIC").

ACTION: Proposed rule.

SUMMARY: The FDIC, having determined that it is not unlawful under the Glass-Steagall Act for an insured nonmember bank to establish or acquire a bona fide subsidiary that engages in securities activities nor for an insured nonmember bank to become affiliated with a company engaged in securities activities, proposes to: (1) Define bona fide subsidiary, (2) limit a bank's permissible investment in a securities subsidiary, (3) require notice of intent to invest in such a subsidiary, (4) limit the permissible securities activities of nonmember bank subsidiaries, and (5) place certain other restrictions on loans, extensions of credit, and other transactions between nonmember banks and their subsidiaries or affiliates that engage in securities activities.

DATE: Comments must be received by July 18, 1983.

ADDRESS: Send comments to Hoyle L. Robinson, Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, D.C. Comments may be hand delivered to Room 6108 between the hours of 8:30 a.m. and 5:00 p.m.

FOR FURTHER INFORMATION CONTACT: Pamela E.F. LeCren, Senior Attorney, Legal Division (202-389-4171), Room 4126E, 550 17th Street, N.W., Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION: On August 23, 1982, the Board of Directors of the FDIC adopted a policy statement concerning the applicability of the Glass-Steagall Act to securities activities of subsidiaries of insured nonmember banks. The

policy statement which was published in the Federal Register on September 3, 1982 (47 FR 38984) concluded that, in the opinion of the Board of Directors, the Banking Act of 1933 (popularly known as the Glass-Steagall Act and codified in various provisions of title 12 of the United Sates Code) does not by its express terms prohibit an insured nonmember bank from establishing an affiliate relationship with or organizing or acquiring a subsidiary corporation that engages in the business of issuing, underwriting, selling or distributing stocks, bonds, debentures, notes, or other securities. Although the policy statement was not designed to address the safety or soundness of such activities, it did state that the FDIC recognized its ongoing responsibility to ensure the safe and sound operation of banks and that, depending on the facts, potential risks can be inherent in a bank subsidiary's involvement in particular securities activities. In keeping with that statement, on September 20, 1982, the FDIC adopted an Advance Notice of Proposed Rulemaking (47 FR 42121; September 24, 1982) designed to solicit comment on the need, if any, for rulemaking with regard to securities activities of subsidiaries of nonmember banks and affiliates of nonmember banks. The notice requested comment on "whether or not it is inherently unsafe or unsound for a bank's subsidiaries to engage in securities or whether there is a need to condition or restrict such activities (on a case-by-case basis or by regulation) even though they may not be inherently unsafe or unsound in all instances."

Comment was specifically directed to the following: (1) Whether it is inherently unsafe or unsound for insured nonmember banks to establish or acquire subsidiaries that will engage in securities activities or for insured nonmember banks to be affiliated with the business engaged in securities activities; (2) whether certain securities activities when engaged in by subsidiaries of insured nonmember banks pose safety and soundness problems whereas others do not; (3) whether, and in what circumstances, securities activities of insured nonmember banks should be considered unsafe or unsound; (4) whether securities activities of subsidiaries present conflicts of interest that warrant

restricting the manner in which the bank may deal with its securities subsidiary (or its securities affiliate), or the manner in which common officers or employees may function, etc.; (5) should securities activities be limited to subsidiaries of banks of a certain asset size, banks with a certain composite rating, etc.; (6) should nonmember banks obtain FDIC's prior approval before establishing or acquiring subsidiaries that engage in securities activities (in all cases, in some cases, or not at all); (7) do the potential benefits, if any, that would be available to insured nonmember banks as a result of competing in the securities area through subsidiaries offset potential disadvantages to the bank; and (8) are there any perceived public harms in insured nonmember banks embarking on such activities. Additionally, comment was requested on the propriety of defining the term "bona fide subsidiary" and whether certain listed criteria should be included in that definition.

In conjunction with this proposal, and in addition to carefully considering the comments received in response to the advance notice, the FDIC closely reviewed the purposes of the Glass-Steagall Act. The Glass-Steagall Act was, in many respects, a reaction to the collapse of the banking industry in the 1930's. The legislative history of that statute documents numerous securities related practices prevalent at the time which were felt to pose hazards to the safety and soundness of banks and which were further seen as contributing to, if not causing, the banking collapse. The Supreme Court in *Investment Co. Institute* v. *Camp*, 401 U.S. 617, 630-633 (1971) reviewed and determined to be invalid a regulation by the Comptroller of the Currency permitting national banks to establish and operate "collective investment funds". The Court in doing so discussed the legislative history of the Glass-Steagall Act and articulated the hazards associated with the direct and indirect involvement of banks in securities activities.

The legislative history of the Glass-Steagall Act shows that Congress * * * had in mind and repeatedly focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or indirectly by establishing an affiliate to hold and sell particular investments. The course

places new promotional and other pressures on the bank which in turn create new temptations. *Camp* at 630.

The temptations identified by the Supreme Court were: (1) The association of the affiliate and the bank in the public's mind could impair the public confidence in the bank should the affiliate fare badly; (2) the temptation to shore up the affiliate through bad loans; (3) the temptation to readily make the bank's credit facilities available and make unsound loans to companies in whose stock the affiliate has invested; (4) loss of customer good will if a customer suffers loss after investment in a stock or security associated with a bank affiliate; (5) the promotional interest of investment banking might cause a bank to lend its reputation to the sale of particular stocks and thus risk the undercutting of its reputation; (6) the temptation to make loans for the purpose of acquiring stock or securities sold by the bank's affiliate; (7) the inherent conflict between a bank's promotional interest and its obligation to render impartial investment advice; and (8) the unloading of poor issues by securities affiliates into the trust department of the bank.

The propriety of, and hazards associated with, direct and indirect involvement of banks in securities activities has been the focus of recent legislative proposals, much debate and testimony, and several legal challenges. This proposal is a recognition by the FDIC that at least some of those hazards can and do exist even though, in the FDIC's opinion, a bank's involvement in securities activities is not unsafe or unsound in all instances. This is so especially in view of the highly regulated atmosphere in which the banking and securities industries function today which was not present in 1930. Rather than deny insured nonmember banks the opportunity of acquiring or forming securities subsidiaries because of the presence of some risk, the FDIC is proposing to eliminate or lessen the risks that can be present by placing a number of restrictions on a nonmember bank's indirect involvement in the securities area.

The proposed regulation was prepared with the aid of comments submitted in response to FDIC's Advance Notice of Proposed Rulemaking. Thirty-eight comments were received over

the sixty-day comment period which ended on October 25, 1982. The comments were generally favorable to FDIC's position as set forth in the September 3 policy statement. Three comments were received, however, that were of the opinion that FDIC's policy statement is legally incorrect. The comments were about evenly divided on the need for rulemaking. The most prevalent comment from those opposing any rulemaking was that existing supervisory mechanisms (including FDIC's cease-and-desist authority) are sufficient tools to safeguard bank safety in light of existing securities law and regulations. Some commentors rejected rulemaking as premature and recommended that the FDIC strike a wait-and-see attitude. Those who recognized some purpose to be served by a regulation at this point in time generally observed that securities activities by bank subsidiaries (and/or a bank's relationship with a securities affiliate) are not necessarily unsafe or unsound but can present conflicts of interest.

The conflicts of interest were generally identified by the commenators as connected with the lending function of a bank. Suggested ways to deal with the conflict of interests and ensure the safe and sound operation of banks that are affiliated with and/or have subsidiaries that engage in securities activities included: (1) Disclosure, (2) limiting insider dealing, (3) limiting permissible investments in a securities subsidiary, (4) simply requiring that all dealings with the subsidiary or affiliate be on an "arms length basis", (5) establishing capital guidelines for the subsidiary, (6) prohibiting a bank with a securities subsidiary or affiliate from giving investment advice to its customers, (7) restricting bank entry into the securities area by use of composite rating, asset size, etc., (8) prohibiting a bank from establishing or acquiring a subsidiary that underwrites securities, (9) prohibiting a bank from establishing or acquiring a subsidiary that underwrites equity securities, (10) requiring banks to obtain FDIC approval prior to establishing or acquiring a securities subsidiary, and (11) requiring banks to establish written procedures governing the operation of the subsidiary and the bank's relationship thereto.

Five commentors opposed any approval requirement as well as the use of asset size or composite rating to limit entry.

On the issue of defining "bona fide subsidiary" only four of those commenting felt a definition was inappropriate. Seven commentors felt that the bank's subsidiary should be able to use the bank's facilities in order to reduce the cost of operation. All those addressing a capital requirement and the need for separate corporate formalities were in favor of both. Five commentors felt that the bank and the subsidiary should be able to use the same or similar names and the same management. Three commentors suggested that the FDIC adopt the standard corporate law test in determining whether a corporation is a separate entity similar names and the same management. Three commentors suggested that the FDIC adopt the standard corporate law test in determining whether a corporation is a separate entity or an alter ego of another corporation.

After due consideration, the FDIC has determined to propose a regulation the basic features of which are: (1) Notice of intent to invest in a securities subsidiary; (2) no prior approval requirement; (3) no formalized restrictions on bank entry based on asset size or composite rating; (4) a prohibition on a nonmember bank establishing or acquiring a subsidiary that underwrites securities unless the underwriting activity is on a "best efforts" basis, is restricted to top rated debt securities, or is the underwriting of a money market fund type mutual fund; (5) a twenty percent of capital ceiling on a bank's investment in one or more securities subsidiaries; (6) a limit on the amount of loans or extensions of credit that a bank may make to its securities subsidiary or affiliate; (7) a prohibition on loans for the purpose of acquiring securities underwritten or distributed by the bank's subsidiary or affiliate or the acceptance of such securities as collateral on a loan or extension of credit; (8) prohibiting loans or extensions of credit to companies whose securities are under written by the bank's subsidiary or affiliate unless the securities are highly rated; (9) prohibiting the purchase by the bank's trust department in its sole discretion of securities distributed, underwritten or issued by

the bank's subsidiary or affiliate; and (10) prohibiting the transaction of business through the bank's trust department with the bank's securities subsidiary or affiliate unless those transactions are comparable to transactions with an unaffiliated securities company. Additionally, the proposed regulation contains a definition of bona fide subsidiary which requires that, in order for the subsidiary to be considered bona fide, the subsidiary be adequately capitalized; its operations be physically separate from that of the bank; separate records and corporate formalities be observed; separate employees be maintained; and that the subsidiary function independently from, and not be identified with the bank. Further explanation of the provisions of the proposed regulation follow.

1. Bona Fide Subsidiary

The proposed definition of bona fide subsidiary includes elements typically used by courts in determining whether or not an entity is the alter ego of another corporation. In defining bona fide subsidiary as it has the FDIC is not necessarily indicating that any association between a bank and its securities subsidiary in the public mind could harm the reputation of the bank. The definition is designed rather to ensure the separateness of the subsidiary and the bank inasmuch as the bank is prohibited by the Glass-Steagall Act from engaging in many securities activities that would otherwise be permissible to a nonbanking corporation. If the subsidiary is not sufficiently distinct from the parent bank, the subsidiary may be found to be the alter ego of the bank and the bank held to be engaging in securities activities in violation of the Glass-Steagall Act.

Among the listed criteria contained in the definition is that the operation of the subsidiary be physically separate from that of the bank. The subsidiary's operations need not be conducted in a building other than the one in which the parent bank is located or one not owned or leased by the parent bank so long as it is clear from the location of the subsidiary's offices, and access thereto, that the subsidiary's operation is distinct from that of the bank.

Just how physically separate the operations are will play a role in determining whether or not the subsidiary conducts business separately from, and is not identified with, the banking business of the parent bank. Separate employees, observance of separate corporate formalities, and maintenance of separate records also play a role in that determination.

The FDIC is presently of the opinion that the subsidiary should have a different name from the bank in order for the subsidiary's business not to be identified with the banking operations of its parent. A different name is not only relevant in determining whether the subsidiary will be considered an alter ego of the bank, it is seen by the FDIC as important in preventing public confusion as to the insured status of investments placed with the subsidiary. Insured nonmember banks should note that if the subsidiary conducts only activities that the bank could itself conduct, the need for the subsidiary not to be identified with the bank is reduced. The FDIC would still, however, require that there be sufficient differentiation between the bank and its subsidiary in advertisements, promotions, etc. so as to avoid any public misconceptions as to the insured status of any accounts or other investments held by the subsidiary. Comment is specifically requested as to whether or not the proposed regulation should expressly reflect the above or whether a different name than the parent bank is not necessary in order for the securities activities of the subsidiary not to be identified with the bank.

As articulated by the courts, the presence of adequate capital is one of the most important factors in the inquiry as to the bona fide status of a separate corporation. Adequate capital is also very important from a safety and soundness point of view as the parent bank is less likely to be harmed if the subsidiary has adequate capital and thus can itself absorb losses as well as liabilities arising from the securities operations. The FDIC has not proposed a definition of adequate capital inasmuch as the adequacy of any particular subsidiary's capital can vary from a safety and soundness point of view. The FDIC would, of course, expect that the bank's subsidiary will comply with any applicable capital

requirements imposed by the Securities and Exchange Commission ("SEC") or imposed under State law. This is merely a starting point, however, and the FDIC reserves the right to determine that the subsidiary's activities and/or the parent bank's condition warrant that the subsidiary be capitalized over and above any such requirement. It is FDIC's intention to make such an assessment during the "notice" period (see subparagraph d of the proposal) and to inform the bank whether in FDIC's opinion the capital position of the subsidiary is adequate. It is FDIC's belief that such a flexible approach will better serve FDIC's supervisory interest of ensuring the safety and soundness of insured nonmember banks.

2. Underwriting

The proposal is designed, in part, to limit a bank's indirect exposure to the risks associated with the underwriting of securities. Subparagraph b(1)(i) of the proposal prohibits a bank from establishing or acquiring a subsidiary that underwrites securities unless the subsidiary's underwriting activities in which the bank itself cannot lawfully engage meet one of the three alternative requirements: (1) The subsidiary's underwriting activities are on a "best efforts" basis; (2) the subsidiary's underwriting activities are confined to underwriting of top rated debt securities, or (3) the subsidiary underwrites shares in mutual funds that invest solely in investments traditionally associated with money market funds.

"Best efforts" underwriting within the meaning of this proposal is an underwriting wherein the underwriter agrees only to use best efforts to sell an issue but does not agree to purchase any unsold securities for its own account. Inasmuch as the subsidiary will not be at risk in underwriting a security (be it debt or equity, rated or unrated) if the underwriting is on a "best efforts" basis, the possibility of any adverse impact to the parent bank arising from the "best efforts" underwriting of its subsidiary is lessened, if not removed. Furthermore, the conflicts of interest as articulated by the Supreme Court in *ICI* v. *Camp* are also minimized

especially when the lending restrictions contained elsewhere in this proposal are taken into consideration.

If a bank subsidiary chooses to engage in firm commitment or any other non-"best efforts" underwriting, the proposal limits the underwriting to top rated debt obligations. Equity securities may not be underwritten on other than a "best efforts" basis. Equity securities as a class pose more risk to an underwriter than do debt securities. It is because of the relative safety of debt obligations, coupled with the fact that many insured nonmember banks are themselves familiar with the underwriting of debt obligations, that the FDIC opted to distinguish between debt and equity securities and prohibit nonmember banks from establishing or acquiring a subsidiary that underwrites the latter. No similar restriction on the affiliation of nonmember banks with securities companies that underwrite equity securities is being proposed. There would appear to be less of a possibility that losses suffered by the bank's parent or sister affiliate due to the underwriting of equity securities will have adverse impact on the bank. This is so especially if the parent's ability to move funds out of the bank is limited. One of the purposes of the restrictions imposed by this proposal on insured nonmember banks when lending to securities affiliates is to limit the parent's ability to do so.

The proposal alternatively permits the establishment or acquisition of a subsidiary that underwrites mutual funds if the fund's investments are exclusively limited to the types of investments associated with money market funds, *i.e.*, bank certificates of deposit, bankers' acceptances, United States government obligations, obligations of the United States government agencies, etc. Mutual funds that are more speculative in nature, *i.e.*, whose value per share tend to fluctuate more due to the nature of the investments (commodities, futures contracts, oil leases, equity securities) may not be underwritten other than on a "best efforts" basis. The distinction is being drawn as to money market fund type mutual funds under the proposal as it is FDIC's belief that such funds tend to be more stable. The underwriting of such

funds by insured nonmember bank subsidiaries should therefore pose less risk to insured nonmember banks.

The proposal represents a compromise from among a number of alternatives which included prohibiting securities underwriting altogether or limiting underwriting solely to "best efforts". The proposal as structured permits insured nonmember bank subsidiaries some flexibility in their securities activities and yet offers more protection to the parent bank than would, for example, a totally open-ended approach. The FDIC is specifically interested in receiving comments on whether an insured nonmember bank's ability to establish or acquire a securities underwriting subsidiary should be limited in the fashion described above, should be limited in some other manner, should be prohibited entirely, or does not need to be restricted so long as the subsidiary is bona fide.

3. Filing of Notice

The written notice requirement is designed to apprise the FDIC of a bank's intent to establish or acquire a subsidiary that engages in any securities activity including acting as an adviser to an investment company. Notice is to be filed with the regional office for the region in which the bank is located. Notice of intent is not limited to underwriting activities as from a supervisory standpoint, the FDIC has an interest in being aware of any indirect securities activities of an insured nonmember bank. The proposal further requires that, in addition to the 60-day advance notice, a bank file written notice with the regional office within 10 days after the acquisition is consummated or the subsidiary commences operation, whichever is first. This will provide FDIC with information as to which insured nonmember banks pursued to completion their planned acquisition or establishment of a securities subsidiary.

The proposal does not specify the content of the written notice of intent. By not specifying the content of the notice, the FDIC is permitting a bank to satisfy the notice requirement in any way it finds most convenient. For example, if the subsidiary will be

registered with the SEC, a copy of the SEC filing may simply be forwarded to the appropriate FDIC regional office.

It is the FDIC's intent to use the notice as a point of reference and for the regional office to contact the bank seeking further information if the bank's condition or other facts warrant closer review. The proposal thus requires that the notice be received in the regional office at least 60 days prior to the acquisition or commencement of operation, whichever is first. The 60-day notice period can be waived at the FDIC's discretion where such period is impracticable, *i.e.*, where the acquisition is the result of a purchase and assumption transaction or an emergency merger. The notice requirement is not an approval process although the FDIC would not be precluded from intervening in the intended acquisition or establishment of the subsidiary if such intervention was warranted (for example, if the subsidiary would not appear to meet the requirements for a bona fide subsidiary).

The proposal does not require written notice when a bank becomes affiliated with a securities company. For the most part, affiliation with a securities company will arise out of a change in bank control or come to FDIC's attention when a bank seeks deposit insurance. As the FDIC will become aware of the affiliation in both instances prior to consummation, there is no need to create an additional notice requirement under this proposal.

4. Lending Restrictions

Paragraph (e) contains several restrictions designed to prevent the abuse of a bank's credit facilities. Such abuse can arise in several ways, such as, the making of loans in order to maintain or create a market for securities underwritten or distributed by the bank's subsidiary or affiliate. The proposal thus prohibits both the acceptance of securities distributed or underwritten by the bank's subsidiary or affiliate as collateral on loans and the making of loans for the purpose of acquiring such securities. It also seeks to address the temptation for a bank to make unsound loans to companies whose securities are underwritten or distributed by the bank subsidiary or affiliate in an effort to improve the condition of

the company and the marketability of the securities that are underwritten or distributed. The FDIC considered prohibiting all loans to companies whose securities are underwritten by a bank's subsidiary or affiliate but rejected that approach as overly broad. Instead the proposal prohibits a bank from lending to any such company unless the securities are rated (prior to the loan) by nationally recognized rating service and the rating is in the top four rating categories. As there would seem to be less of an incentive to make questionable loans for the purpose of maintaining or creating a market for company's securities where the securities are highly rated and thus marketable, there would appear to be little or no reason to prohibit lending to such companies.

It should be noted that paragraph (e)(3) of the proposal will have the effect of prohibiting loans to mutual funds whose shares are underwritten or distributed by a bank's subsidiary or affiliate. This is so because a mutual fund is a "company" within the meaning of that term under the proposal and the shares of a mutual fund are not rated. Loans to mutual funds that are money market funds are separately treated under paragraph (e)(4). Consideration was given to exempting mutual funds and money market funds from the reach of paragraphs (e)(3) and (e)(4). Such an exemption was rejected inasmuch as such a fund's credit needs are most likely to arise when the fund is having liquidity problems. (If interest rates should rise sharply and large numbers of shareholders, especially institutional investors, redeem their shares to put their money directly into higher-paying investments, a fund could face a liquidity crisis.) A bank may be tempted a make an unsound loan to the fund in order to prevent the fund from suffering a loss by selling portfolio assets at a depressed price to meet liquidity needs.

Money market funds have been targeted within the lending prohibition despite the relative stability of most money market funds. At present there is no self-regulatory organization such as the National Association of Securities Dealers ("NASD") to watchdog money market funds, *i.e.*, inspect funds to make sure their books are in order and that they are obeying SEC rules

barring such things as management self-dealing and misleading advertising. The SEC has urged that such a group be formed so that bookkeeping problems and fraudulent conduct can be detected early, avoiding loss to investors. Presently the SEC has only 45 fund inspectors to cope with 1,830 mutual funds (including money market funds) registered with the SEC as of September 1982. As of that date those funds had total assets of $315 billion which represented a growth from $74 billion assets of a seven-year period. (As of February 1983 the total asset figure for mutual funds dropped to $291.1 billion.)

Paragraph (e)(7), rather than (e)(3) or (4), is controlling when considering loans or extensions of credit to a mutual fund or a money market fund that is a subsidiary of an insured nonmember banks as that term is defined in the proposal. The bank is permitted to lend to the fund but the loans are subject to the restrictions found in section 23A of the Federal Reserve Act (12 U.S.C. 371c). The difference in treatment is being proposed as it was initially felt that the protections supplied by the restrictions of section 23A when a bank lends to a related mutual fund, that are not present when lending to an unrelated fund, may warrant permitting loans to the former under paragraph (e)(7) while not permitting loans to the latter under subparagraphs (e) (3) or (4). Comment is specifically directed to whether unrelated and related funds alike should be treated the same and given the benefit of being able to obtain loans if the provisions of section 23A are observed.

Paragraphs (b)(1)(i), (e)(3), and (e)(4) of the proposal when read together provide that a bank may lend to all companies whose debt securities are underwritten by the bank's subsidiary and all companies whose non-debt securities are rated and are underwritten by the bank's subsidiary. (The non-debt securities must be underwritten on a "best efforts" basis in order to comply the (b)(1)(i)). Paragraphs (e)(3) and (e)(4) also expressly cover indirect as was well as direct loans. The prohibition thus covers a situation where an individual obtains a loan and transfers the proceeds to a comply whose securities are underwritten or

distributed by the bank's subsidiary or affiliate, *i.e.*, the language of paragraphs (e)(3) and (e)(4) is designed to prevent evasion of the prohibition simply by running the loan through another party.

Paragraph (e)(7) subjects extensions of credit to the bank's subsidiary to the same loan ceiling that would be applicable under section 23A of the Federal Reserve Act if the subsidiary were an affiliate for the purposes of that statute. Loans or extensions of credit to the bank's affiliate as that term is defined herein are already covered by the language of section 23A and thus placing affiliates under the restrictions of paragraph (e)(7) does not establish any additional requirements. Paragraph (e)(8) covers loans or extensions of credit to an investment company advised by a bank's subsidiary and places those extensions of credit under the same restrictions that would have been applicable under section 23A of the Federal Reserve Act had that subsidiary been an affiliate within the meaning of section 23A. Risks can be present even where a bank subsidiary merely advises an investment company. Section 23A covers extensions of credit to investment companies advised by bank affiliates thus placing affiliates under the restrictions of subparagraph (e)(8) does not establish any additional requirements. The FDIC is interested in receiving public comment on whether or not the proposed regulation should prohibit the making of any extension of credit to the bank's securities subsidiary or a subsidiary that acts as an investment adviser to an investment company rather than permitting such extensions of credit if they comply with section 23A.

5. Trust Department Restrictions

One of the safety and soundness problems associated with securities activities of subsidiaries and affiliates of nonmember banks is dumping of poor securities into the bank's trust department. The proposal seeks to eliminate that risk by prohibiting an insured nonmember bank from purchasing, in its sole discretion as fiduciary or co-fiduciary on behalf of any trust account, securities distributed, underwritten or issued by the bank's subsidiary

or affiliate. Purchasing of securities distributed or underwritten by an investment company advised by the bank's subsidiary or affiliate is also prohibited. The proposal would permit either purchase if the bank is directed to do so. This provision of the proposal, as well as the provision which requires all trust department transactions with the bank's subsidiary or affiliate to be comparable to transactions with unrelated securities companies (see paragraph (e)(2)), merely restates the common law obligation of a fiduciary to refrain from any self-dealing in the administration of a trust account. As stated in FDIC's manual of examination policies with respect to trust department examinations, "It is a general axiom that a bank has a definite moral responsibility, as well as legal, not to deal with itself in the administration of a fiduciary account." The manual also goes on to state that a bank should not invest fiduciary funds in its own obligations or stock unless court order, local law or the trust instrument authorizes the purchase and retention of the obligation or stock or specific authority for the investment is obtained from all interested parties.

The proposal does not prohibit a bank's trust department from using the broker/dealer services of its subsidiary or affiliate to execute transactions on behalf of its fiduciary accounts. The trust department's decision to utilize the related broker/dealer must fully comport, however, with the bank's fiduciary obligation to its trust department customers. The transactions must also be executed on comparable terms with transactions with unrelated securities companies so that the trust department will not derive any additional benefits from the administration of the trust above and beyond its normal fee for trust account administration. This requirement will also insulate the bank from the possibility that its securities affiliate will drain off profits from the bank by setting a higher than normal fee for executing transactions.

6. Investment Ceiling

Paragraph (b)(2) limits the permissible investment by an insured nonmember bank in one or more securities subsidiaries to

twenty percent of the bank's equity capital as defined by FDIC's statement on capital adequacy. The limit is subject, however, to any lesser investment cap established by State law. The proposed investment limitation is designed to create a buffer between the operation of a subsidiary (or subsidiaries) and the bank in addition to the buffer provided by the subsidiary's capital position. Although the FDIC will have the authority under section 10 of the FDI Act (12 U.S.C. 1820) to examine the affairs of the securities subsidiaries or affiliate as shall be necessary to disclose fully the relations between the bank and those subsidiaries or affiliates and the effect of such relations upon the bank, the FDIC does not actually "supervise" the subsidiaries or affiliates. It will be difficult for the FDIC to accurately judge the adequacy of a subsidiary's capital from a safety and soundness point of view on a daily basis, especially as factual circumstances may vary. The FDIC therefore has determined that the possibility of adverse impact to the bank should the subsidiary fail or suffer extreme loss is appropriately limited by placing a limit on the bank's investment in the subsidiary. Twenty percent of equity capital was chosen rather than a smaller figure in order to accommodate smaller banks that would otherwise be precluded from investing, *i.e.*, the resulting investment ceiling would have been unrealistically small thus precluding any investment by smaller insured nonmember banks. An insured nonmember bank's investment in a securities subsidiary will not be counted toward the bank's regulatory capital.

7. Affiliation with a Securities Company

Paragraph (c) of the proposal is merely a restatement of FDIC's interpretive ruling that the Glass-Steagall Act does not reach the affiliation of an insured nonmember bank with a securities company. The lawfulness of such an affiliation is subject, however, to any other applicable Federal or State law. For example, the Change of Bank Control Act (12 U.S.C. 1817) or the Bank Holding Company Act (12 U.S.C. 1841) may be applicable where a securities company seeks to acquire control of an

insured nonmember bank. Insured nonmember banks are reminded that the securities activities of any affiliate should separate and distinct from the bank in order to avoid any public confusion and/or a finding that the bank is itself engaging in securities activities not permitted to it under the Glass-Steagall Act.

8. Construction of the Terms "Underwrite", "Distribute", and "Security"

It is not FDIC's intent by this proposal to prevent a bank subsidiary from engaging in any securities underwriting activity that an insured nonmember bank may itself lawfully pursue. Those activities are set forth in 12 U.S.C. 24(7th) and include underwriting obligations of the United States, general obligations of any state or political subdivision thereof, and numerous other obligations specifically named therein. Insured nonmember banks should keep in mind while assessing this proposal that the terms "underwrite" and "distribute", and the phrase "stocks, bonds, debentures, notes, or other securities" are to be construed consistently with the securities laws and regulations except where the context requires otherwise. A securities subsidiary or affiliate of an insured nonmember bank while engaged in the conduct of securities activity will be subject to the security laws and regulations, the oversight of the Securities and Exchange Commission, and oversight by entities such as the NASD. The above terms are therefore to have the meaning proscribed by the securities laws and regulations when used in connection with the subsidiary or affiliate. References in the proposal to these terms as used in conjunction with an insured nonmember bank (see paragraphs (b)(1)(i), (f) and (g)) are to be construed consistently with the Glass-Steagall Act.

The courts have repeatedly stated that the prohibitions of the Glass-Steagall Act are to be defined with reference to the purposes of the statute and that the definitions of the terms used therein (*i.e.*, distribute, underwrite, security) do not necessarily coincide with the definition of the same terms as used in the

securities laws. (*See A.G. Becker Inc.* v. *Board of Governors of the Federal Reserve System*, 693 F.2d 136 (D.C. Cir. 1982); *National Association of Securities Dealers, Inc.* v. *Securities and Exchange Commission*, 420 F.2d 33 (D.C. Cir. 1969); *New York Stock Exchange Inc.* v. *Smith*, 404 F. Supp. 1091 (D.D.C. 1975), *vacated on other grounds*, 562 F.2d 736 (D.C. Cir. 1977)). The FDIC therefore intends to utilize a functional analysis in determining whether a particular activity constitutes underwriting or distributing of a security under the Glass-Steagall Act. In this regard, insured nonmember banks should note that the United States District Court for the District of Columbia recently concluded that short term commercial paper does not constitute a security for the purposes of the Glass-Steagall Act and therefore it is not unlawful for a bank to act as an agent in the sale thereof it the guidelines established by the Federal Reserve Board are observed. (*See A.G. Becker*, *supra*.) The FDIC will follow this and any interpretive ruling by the courts concerning the scope of the Glass-Steagall Act in applying this regulation.

9. Definition of "Affiliate", "Subsidiary", and "Extension of Credit"

The proposal defines the term "affiliate" to mean a company that directly or indirectly controls an insured nonmember bank and any company that is in turn controlled by such a company. "Control" is defined as the power to directly or indirectly vote 25 percent of a bank or company's stock; the ability to control the election of a majority of a bank's or company's directors or trustees; or the ability to exercise a controlling influence over the management and policies of a bank or company. At a minimum the proposal would reach a bank's parent company, a company that controls 25% or more of the bank's stock, and companies controlled by either of the above, *i.e.*, sister affiliates.

The term "subsidiary" is defined to mean a company controlled by a bank. As "company" is defined to include corporations other than banks, partnerships, business trusts, associations, joint ventures, pool syndicates or other similar business organizations,

a mutual fund (*i.e.*, a business trust) can be a subsidiary of a bank and a securities company operated by several banks in a co-operative effort can be considered a subsidiary of each of the banks. The term "extension of credit" has the same meaning as found in Federal Reserve Board Regulation O (12 CFR 215.3) which concerns insider transactions.

10. Public Hearing on Proposed Regulation

The Board of Directors has concluded that it is appropriate for the FDIC to hold a public hearing at which it will accept both oral and written comments regarding this proposal. A formal notice of agency hearing setting forth the date, time, and other particulars regarding that hearing appears elsewhere in today's Federal Register.

11. Regulatory Flexibility Analysis/Paperwork Reduction Act

In accordance with FDIC's policy statement entitled "Development and Review of FDIC Rules and Regulations" and the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), the FDIC conducted an analysis of the impact of the proposed regulation. The result of that analysis follows:

The proposed regulation would prohibit a nonmember bank from establishing or acquiring a subsidiary that underwrites equity securities. As equity underwriting is, on the average, more profitable than underwriting of debt securities, limiting the bank subsidiary's ability to underwrite securities to underwriting of debt obligations reduces the subsidiary's potential income. The increased income associated with equity underwriting is, however, directly a measure of the increased difficulty of a successful underwriting, *i.e.*, debt issues are easier to move and thus the underwriter tends to receive less compensation. Underwriting profits range from less than 1% to 5% of issue size for debt, with the average being less than 1%, and from 4% to 10% for common stock with preferred stock being less profitable than common stock. Profits will depend upon issue size (economies of scale reduce the percentage as issue size increases) and risk

(credit rating of issuer). Although a bank subsidiary could underwrite equity securities on a "best efforts" basis, the underwriting profits from any best efforts undertaking would be lessened (even in the case of an equity issue), as a "best efforts" underwriting involves less risk to the underwriter and thus generates a smaller fee.

Setting the investment cap in the subsidiary at 20% of equity capital will enable even relatively small nonmember banks to indirectly compete in the securities market through a subsidiary. These new entrants into the market can be expected to: (1) Provide increased access to capital markets where access may have been previously limited (*i.e*, the smaller issuer generally finds it difficult to attract underwriters), and (2) lower issuer cost of tapping into the capital markets. As the number of entrants increases, competitive bid offerings are likely to increase. Competitive bid offerings tend to be less expensive than negotiated offerings.

Additionally, the increase of entrants into the securities underwriting market would tend to increase the liquidity of any new issue thus permitting underwriters (bank related and nonbank related alike) to distribute securities at higher prices as the securities will be more attractive. The resulting increased activity in the secondary market raises the possibility than an investor can unload a security quickly at a reasonable price. This should mean that an investor is willing to pay more for the security.

We expect most nonmember banks to form subsidiaries that engage in some form of discount brokerage rather than underwriting. The presence of new entrants into this market can be expected to further decrease costs to investors (both users of discount brokerage and full service brokerage) as fee and service competition increases. A bank subsidiary would not appear to have any advantage in this area. Increased advertising that should result from the increased competition should raise investor awareness and participation with an overall benefit to the economy as more money moves into the capital markets.

Under the proposal a bank subsidiary will be able to underwrite or distribute shares in a money market fund and/or act as an investment adviser to a money market fund. If the new money market funds that are established as a result of the proposal invest in bank certificates of deposits or other bank-issued money instruments such as repurchase agreements, we can expect an increase in the amount of loanable funds. Additionally, it can be expected that the presence of new bank-related money market funds would reduce the existing flow of funds to the money center banks. A bank subsidiary-sponsored money market fund should not have any advantages over a non-bank related money market fund as competition between the two types of funds should be on the basis of competitive pricing and services. Banks cannot lawfully utilize their market power to obtain any advantages for their underwriting subsidiary as banks are subject to the anti-tying provisions of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972).

Although some observers have alleged that banks, if permitted to underwrite municipal revenue bonds or other securities, would have an unfair tax advantage as banks may deduct interest paid on funds borrowed to hold tax-exempt securities, that advantage would not extend to the bank's subsidiary. Nor can the bank subsidiary use the liberal loan loss calculation available to banks that will itself be phased out for banks by 1988. Nor do we find that banks will have lower capital costs in establishing or acquiring securities subsidiaries. Although in the past banks have had lower average interest costs due to Regulation Q ceilings, those ceilings will be completely phased out on or before January 1, 1984 and the advent of the new money market rate account authorized by the Garn-St Germain Depository Institutions Act increases the cost of funds available to banks. Even then the relevant cost consideration is not the average cost of funds but the marginal cost. Commercial banks that enter new product markets by establishing or acquiring subsidiaries must borrow at market rates and therefore do not have a lower marginal cost of funds. Last, the charge that a bank subsidiary would have an

unfair advantage in attracting investors because of the bank's name recognition and the bank's knowledge of existing customers' is not valid due to the restrictions in the proposal.

There might be overall cost to the economy if the advent of bank securities subsidiaries can be expected to jeopardize the viability of the nation's banking institutions. That does not appear to be the case, however, and certainly is not the case when the structure of the proposal is taken into consideration. For example, the proposal is structured so as to insulate the bank from the activities of the subsidiary as well as any financial repercussions generated by losses on the part of the subsidiary. The subsidiary will only be able to underwrite top rated debt securities; underwrite on a "best efforts" basis which does not put its capital at risk; or underwrite shares in money market funds which are recognized as relatively sound investments. There is, thus, less of a likelihood that the subsidiary will incur losses that it could not safely absorb. The bank is further insulated as it will not be able to make purpose loans; prop up companies whose securities are underwritten by the bank's subsidiary or affiliate; make excessive loans to its securities subsidiary or affiliate; invest an excessive amount of capital in the subsidiary; or move poor issues into the bank's trust department.

The notice requirements contained in this proposal do not constitute "collections of information" for purposes of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*) and therefore are not subject to the Office of Management and Budget ("OMB") clearance provisions of that Act. This is because the notice requirements fall within the exception to the definition of "information" set out in § 1320.7(k)(1) of the recently issued OMB regulations implementing the "collection of information clearance" provisions of the Act (5 CFR 1320). It is recognized, however, that the notice requirements do place an affirmative obligation on a bank to notify the FDIC of its intended action and to confirm whether or not the subsidiary was acquired or established. Costs associated with these notices would appear to be minimal. The proposed regulation does not specify the content of

the written notices or require the bank to provide any specific information. Inasmuch as the bank subsidiary will likely be filing with the Securities and Exchange Commission, no additional paperwork burdens of any kind should be created.

The proposal may duplicate, overlap, or conflict with existing Federal laws and regulations governing the establishment and operation of securities companies; Section 23A of the Federal Reserve Act (12 U.S.C. 371c); the Bank Service Corporation Act, as amended by the Garn-St Germain Depository Institutions Act (12 U.S.C. 1861 *et seq.*); and the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*).

List of Subjects in 12 CFR Part 337

Banks, banking, Securities, State nonmember banks.

In consideration of the foregoing, the FDIC hereby proposes to amend Part 337 of title 12 of the Code of Federal Regulations as follows:

PART 337—UNSAFE AND UNSOUND BANKING PRACTICES

1. The authority citation for Part 337 is as follows:

Authority: Sec. 6, 64 Stat. 876, 12 U.S.C. 1816; sec. 9, 64 Stat. 861-882, 12 U.S.C. 1819; sec. 18(j)(2); 92 Stat. 3664, 12 U.S.C. 1828(j)(2), sec. 422, 96 Stat. 1469. (Pub. L. 97-320).

2. It is proposed that Part 337 be amended by adding the following new § 337.4:

§ 337.4 Securities activities of subsidiaries of insured nonmember banks: Bank transactions with affiliated securities companies.

(a) Definitions: for the purposes of this section,

(1) "Affiliate" shall mean any company that directly or indirectly, through one or more intermediaries, controls an insured nonmember bank and shall include any company controlled by a company that controls an insured nonmember bank.

(2) "Bona fide subsidiary" means a subsidiary of an insured nonmember bank that at a minimum: (i) Is adequately capitalized; (ii) is physically separate in its operations from the operation of the bank; (iii) maintains separate accounting and other corporate records; (iv) observes separate formalities such as separate board of directors meetings; (v) maintains separate employees who are compensated by the subsidiary; and (vi) conducts business separately from, functions independently of, and is not identified with, the banking business of the insured nonmember bank.

(3) "Company" shall mean any corporation (other than a bank), any partnership, business trust, association, joint venture, pool syndicate, or other similar business organization.

(4) "Control" shall mean the power to directly or indirectly vote 25 per centum or more of the voting stock of a bank or company; the ability to control in any manner the election of a majority of a bank's or company's directors or trustees; or the ability to exercise a controlling influence over the management and policies of a bank or company.

(5) "Extension of credit" shall mean the making or renewal of any loan, a grant of a line of credit, or an extending of credit in any manner whatsoever, and includes, but is not limited to:

(i) A purchase whether or not under repurchase agreement, of securities, other assets, or obligations;

(ii) An advance by means of an overdraft, cash item, or otherwise;

(iii) Issuance of a standby letter of credit (or other similar arrangement regardless of name or description);

(iv) An acquisition by discount, purchase, exchange, or otherwise of any note draft, bill of exchange, or other evidence of indebtedness upon which a natural person or company may be liable as maker, drawer, endorser, guarantor, or surety;

(v) A discount of promissory notes, bills of exchange, conditional sales contracts, or similar paper, whether with or without recourse;

(vi) An increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for: (A) Accrued interest or (B) taxes, insurance, or other expenses incidental to the existing indebtedness;

(vii) And any other tranasaction as a result of which a natural person or company becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.

(6)"Investment quality debt security" shall mean a marketable obligation in the form of a bond, note, or debenture the investment characteristics of which are not predominantly speculative and shall include obligations rated by a nationally recognized rating service that have a rating in the top four rating categories.

(7) "Subsidiary" shall mean any company controlled by an insured nonmember bank and any company a majority of whose directors or trustees are directors or trustees of an insured nonmember bank.

(b) Investment in securities subsidiaries.

(1) An insured nonmember bank may not establish or acquire a subsidiary that engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes or other securities; conducts any activities for which the subsidiary is required to register with the Securities and Exchange Commission as a broker/dealer; acts as an investment adviser to any investment company; or engages in any other securities activity unless:

(i) The subsidiary's underwriting activities that would not be authorized to the bank under section 16 of the Glass-Steagall Act (12 U.S.C. 24(7th)) as made applicable to insured nonmember banks by section 21 of the Glass-Steagall Act (12 U.S.C. 378) are, and thereafter continue to be: (A) On a "best efforts" basis, or (B) are limited to, and thereafter continue to be limited to, underwriting of investment quality debt securities or underwriting of mutual funds whose investments are exclusively limited to obligations of the United States or United States government

agencies, repurchase agreements involving such obligations, bank certificates of deposit, banker's acceptances and other bank money instruments, short-term corporate debt instruments, and other similar investments normally associated with a money market fund.

(ii) The subsidiary is, and thereafter continues to be, a bond fide subsidiary.

(2) An insured nonmember bank's investment in a subsidiary under (b)(1) shall not exceed in the aggregate 20 per centum of the bank's equity capital as defined in FDIC's statement on capital adequacy (46 FR 62694) unless prior approval for a greater investment is obtained from the FDIC.

(c) *Affiliation with securities company.* Subject to any other applicable federal or state law, an insured nonmember bank is not prohibited by anything in this section from becoming affiliated with any company that directly or indirectly engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities; acts as an investment adviser to any investment company; conducts any activity for which the affiliate must register with the Securities and Exchange Commission as a broker/dealer; or engages in any other securities activity so long as the securities business of the affiliate is kept separate and distinct from the banking business of the insured nonmember bank.

(d) *Filing of Notice.* Every insured nonmember bank that intends to acquire or establish a subsidiary that: (1) Engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities; (2) acts as an investment adviser to any investment company that sells, distributes or underwrites any such security; (3) conducts any activity for which the subsidiary is required to register with the Securities and Exchange Commission as a broker/dealer; or (4) engages in any other securities activity, shall notify the regional director of the region in which the bank is located. Notice shall be in writing and must be received in the regional office at least 60 days prior to consummation of the acquisition or commencement of the operations of

the subsidiary, whichever is earlier. The banks shall also notify the regional office in writing within 10 days after the consummation of the acquisition or commencement of the operation of, the subsidiary, whichever is earlier. The 60-day notice requirement may be waived, in FDIC's discretion, where such notice would be impracticable such as in the case of a purchase and assumption transaction or an emergency merger.

(e) *Restrictions.* An insured nonmember bank which has a subsidiary or affiliate that engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities; or acts as an investment adviser to any investment company that sells, distributes, or underwrites any such security shall not:

(1) Purchase *in its sole discretion* as fiduciary or co-fiduciary any security currently being distributed, underwritten, or issued by such subsidiary or affiliate or purchase *in its sole discretion* as fiduciary or co-fiduciary any security currently being distributed, underwritten or issued by any investment company advised by such subsidiary or affiliate;

(2) Transact business through its trust department with such subsidiary or affiliate unless the transactions are comparable to transactions with an unaffiliated securities company or a securities company that is not a subsidiary of the bank;

(3) Extend credit or make any loan directly or indirectly to any company the stocks, bonds, debentures, notes, or other securities of which are currently being underwritten or distributed by a subsidiary or affiliate of the bank unless the company's stocks, bonds, debentures, notes or other securities that are underwritten or distributed are rated by a nationally recognized rating service and fall within the top four rated categories;

(4) Extend credit or make any loan directly or indirectly to any money market fund whose shares are currently being distributed or underwritten by a subsidiary or affiliate of the bank;

(5) Make loans for the purpose of acquiring: (i) Any stock, bond, debenture, note, or other security currently being distributed or underwritten by such subsidiary or affiliate; (ii) any stock, bond, debenture, note, or other security currently being

distributed or underwritten by an investment company advised by such subsidiary or affiliate; or (iii) stock in, or shares of, such subsidiary or affiliate;

(6) Accept as collateral on a loan: (i) Stock or shares of any company whose stock or shares are currently being distributed or underwritten by such subsidiary or affiliate or (ii) stock or shares of any company which are currently being distributed or underwritten by an investment company advised by such subsidiary or affiliate;

(7) Make any loan or extension of credit to a subsidiary or affiliate of the bank that: (i) Distributes or underwrites stocks, bonds, debentures, notes, or other securities, or (ii) advises any investment company that distributes or underwrites stocks, bonds, debentures, notes, or other securities, if such loans or extensions of credit would be in excess of the limit as to amount, and not in accordance with the restrictions as to collateral, etc., imposed on "covered transactions" established by section 23A of the Federal Reserve Act (12 U.S.C. 371c);

(8) Make any loan or extension of credit to any investment company for which the bank's subsidiary or affiliate acts as an investment adviser if the loan or extension of credit would be in excess of the limit as to amount, and not in accordance with the restrictions as to collateral, etc., imposed on "covered transactions" established by section 23A of the Federal Reserve Act (12 U.S.C. 371c).

(f) Nothing in this section prohibits an insured nonmember bank from establishing or acquiring a subsidiary that sells, distributes, or underwrites stocks, bonds, debentures, notes, or other securities or engages in any other securities activity, if those activities would be permitted to an insured nonmember bank by sections 16 and 21 of the Glass-Steagall Act (12 U.S.C. 24(7th) and 378).

(g) Nothing in this section authorizes an insured nonmember bank to directly engage in any securities activity not authorized to it under section 16 and 21 of the Glass-Steagall Act (12 U.S.C. 24(7th) and 378).

By Order of the Board of Directors, this 9th day of May 1983.

Federal Deposit Insurance Corporation.

Hoyle L. Robinson,
Executive Secretary.

(FR Doc. 83-13187 Filed 5-16-83; 8:45 am)

BILLING CODE 6714-01-M

Federal Register/Vol. 47, No. 186/Friday, September 24, 1982
Proposed Rules 42,121

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 337
Insured Nonmember Banks; Request for Comments

AGENCY: Federal Deposit Insurance Corporation ("FDIC").

ACTION: Advance Notice of Proposed Rulemaking.

SUMMARY: The FDIC, having concluded that the Banking Act of 1933 (commonly known as "the Glass-Steagall Act") does not prohibit FDIC insured banks which are not members of the Federal Reserve System ("insured nonmember banks") from being affiliated with companies that engage in the securities business or from having bona fide subsidiaries that engage in securities activities, is soliciting comments on (1) whether there is a need for rulemaking to condition, restrict, or prohibit insured nonmember banks from establishing or acquiring subsidiaries that issue, underwrite, sell, or distribute stocks, bonds, debentures, notes, or other securities, (2) whether there is a need for rulemaking in order to restrict the manner in which an insured nonmember bank may deal with a securities affiliate, and (3) what criteria should be taken into account in deciding if a securities subsidiary is in fact a bona fide subsidiary.

DATE: Comments must be received by October 25, 1982.

ADDRESS: Send comments to Hoyle L. Robinson, Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, D.C. 20429. Comments may be hand delivered to Room 6108 between the hours of 8:30 a.m. and 5:00 p.m.

FOR FURTHER INFORMATION CONTACT: Pamela E.F. LeCren, Senior Attorney, Legal Division (202-389-4171), Room 4126-E, or Arthur L. Beamon, Counsel, Legal Division

(202-389-4171), Room 4037, 550 17th Street, N.W., Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION: On August 23, 1982 the FDIC adopted a policy statement on the applicability of the Glass-Steagall Act to securities activities of insured nonmember banks (47 FR 38984). That policy statement expressed the opinion of the Board of Directors that under the Glass-Steagall Act (1) insurance nonmember banks may be affiliated with companies that engage in securities activities, and (2) securities activities of bona fide subsidiaries of insured nonmember banks are not prohibited by section 21 of the Glass-Steagall Act (12 U.S.C. 378) which prohibits deposit taking institutions from engaging in the business of issuing, underwriting, selling, or distributing stocks, bonds, debentures, notes or other securities.

The policy statement applies solely to insured nonmember banks. As noted in the policy statement, the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et. seq.*) places certain restrictions on nonbanking activities. Insured nonmember banks that are members of a bank holding company system need to take into consideration sections 4(a) and 4(c)(8) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(a) and (c)) and applicable Federal Reserve Board regulations before entering into securities activities through subsidiaries.

The policy statement also expressed the opinion of the Board of Directors of the FDIC that there may a need to restrict or prohibit certain securities activities of subsidiaries of nonmember banks. As the policy statement noted, "the FDIC * * * recognizes its ongoing responsibility to ensure the safe and sound operation of insured nonmember banks, and depending upon the facts, the potential risks inherent in a bank subsidiary's involvement in certain securities activities." In view of the Board's opinion as articulated in the policy statement and recent challenges to the safety or soundness of securities activities when carried on by bank subsidiaries,[1] the FDIC is soliciting public comment on,

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1. Two petitions have been filed with the FDIC challenging as unsafe or unsound the proposed entry of insured nonmember banks into the securities area

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among other things, whether or not it is inherently unsafe or unsound for a bank subsidiary to engage in securities activities or whether there is a need to condition or restrict such activities (on a case-by-case basis or by regulation) even though they may not be inherently unsafe or unsound in all instances.

The FDIC is specifically requesting comments that address the following:

(1) Whether it is inherently unsafe or unsound for insured nonmember banks to establish or acquire subsidiaries that will engage in securities activities or for insured nonmember banks to be affiliated with a business engaged in securities activities;

(2) Whether certain securities activities when engaged in by subsidiaries of insured nonmember banks pose safety and soundness problems whereas others do not;

(3) Whether, and in what circumstances, securities activities of insured nonmember banks should be considered unsafe or unsound;

(4) Whether securities activities of subsidiaries present conflicts of interest that warrant restricting the manner in which the bank may deal with its securities subsidiary (or its securities affiliate), or the manner in which common officers or employees may function, etc;[2]

(5) Should securities activities be limited to subsidiaries of banks of a certain asset size, banks with a certain composit rating,

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(footnote continued from previous page)

through subsidiaries. One petition specifically requested that the FDIC adopt a rule prohibiting insured nonmember banks from issuing, underwriting, selling, or distributing stocks, bonds, or other securities or engaging in brokerage activities through subsidiaries or affiliates. The FDIC is issuing this advance notice of proposed rulemaking in part so that it may more ably assess the issues raised in the rulemaking request.

2. The FDIC has in the past imposed conditions in connection with deposit insurance applications where, for example, a trust company owned by a securities dealer wished to obtain FDIC deposit insurance. Conditions that have been imposed due to possible conflicts of interest were (1) that the bank not enter into any securities transactions involving the affiliated securities dealer, (2) that no common director, officer, or employee while acting as a director, officer, or employee of the bank or while on the premises of the bank shall enter into any securities transaction with any customer of the bank, and (3) that the bank

(footnote continued on next page)

etc. (See "Uniform Financial Institutions Rating system", FDIC Press Release PR 126, 1979; FDIC (P-H) p. 5079 for a definition of "composite rating");

(6) Should nonmember banks obtain FDIC's prior approval before establishing or acquiring subsidiaries that will engage in securities activities in all cases, in some cases, or not at all;

(7) Do the potential benefits, if any that would be available to insured nonmenber banks as a result of competing in the securities area through subsidiaries offset potential disadvantages to the banks; and

(8) Are there any perceived public harms in insured nonmenber banks embarking on such activities.

The FDIC is also requesting comment on how to determine if a securities subsidiary is in fact a bona fide subsidiary and not the alter ego of the parent insured nonmember bank. The policy statement issued by the FDIC indicates that, in the opinion of the Board of Directors of the FDIC, Section 21 of Glass-Steagall does not reach the securities activities of a bona fide subsidiary of an insured nonmember bank. If the subsidiary is, however, merely the alter ego of the parent bank, the bank may be deemed to be engaged in securities activities in violation of Section 21 of Glass-Steagall. The FDIC is therefore soliciting comments on whether it would be appropriate to define the term "bona fide" by listing a number of criteria. Would any of the following be appropriately included if criteria were established:

(1) Whether the bank and the subsidiary have the same or similar names so that the public might be confused as to the separate identity of the two;

(2) Whether the subsidiary maintains separate accounting and other records or conducts separate board meetings;

(footnote continued from previous page)
make no loans to any person for the purpose of acquiring securities from the affiliated securities dealer so long as any officer, director, or employee of the bank is a registered representative of the dealer.
See also, for example, Federal Reserve Board Regulation Y (12 CFR Part 225) which contains restrictions that have been imposed on bank holding companies that act as advisors to closed-end investment companies. Those, or similar restrictions which address conflicts of interest may or may not be appropriate in the context under consideration here.

(3) Whether the subsidiary operates out of the same facilities as the parent bank;

(4) Whether the subsidiary has the same directors, officers, and employees as the parent bank and if there are separate employment contracts; and

(5) Whether the subsidiary is inadequately capitalized.

The public is also invited to address the following general issues:

What additional criteria, if any, should be considered? Is it appropriate at all to try to define "bona fide"? If a definition is developed and criteria used, should certain criteria be given more weight than others in making the assessment?

Comments addressing these issues and any other aspects of the general subject of permitting subsidiaries of insured nonmenber banks to engage in securities activities will be welcomed.

List of Subjects in 12 CFR Part 337

Insured nonmember banks, Glass-Steagall Act, Subsidiaries, Securities activities.

By order of the Board of Directors.

Dated: September 20, 1982.

Federal Deposit Insurance Corporation.

HOYLE L. ROBINSON,
Executive Secretary.

(FR Doc. 82-26347 Filed 9-23-82; 8:45 am)

BILLING CODE 6714-91-M

Federal Register/Vol. 47, No. 172/Friday, September 3, 1982
/Notices 38,984

FEDERAL DEPOSIT INSURANCE CORPORATION
Statement of Policy on Applicability of Glass-Steagall Act to Securities Activities of Subsidiaries of Insured Nonmember Banks

AGENCY: Federal Deposit Insurance Corporation.

ACTION: Statement of policy.

SUMMARY: This statement of policy represents the opinion of the Board of Directors of the Federal Deposit Insurance Corporation ("FDIC") as to the applicability of section 21 of the Glass-Steagall Act (12 U.S.C. 378) to the securities activities of subsidiaries of insured nonmember banks.

EFFECTIVE DATE: September 3, 1982.

FOR FURTHER INFORMATION CONTACT: Pamela E. F. LeCren, Senior Attorney, Legal Division, Room 4126E. (202-389-4171). Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION: The Banking Act of 1933, popularly referred to as the Glass-Steagall Act, is codified in various sections of title 12 of the United States Code. Section 21 of the Glass-Steagall Act (12 U.S.C. 378) separates the banking and securities businesses by prohibiting institutions engaged in the business of issuing, underwriting, selling or distributing stocks, bonds, debentures, notes or other securities from also engaging in the business of receiving deposits. Under section 20 of the Act (12 U.S.C. 377), affiliations between banks that are members of the Federal Reserve System and companies principally engaged in securities activities are prohibited.

A number of recent market initiatives by firms engaged in the banking and securities businesses, as well as inquiries from the Securities and Exchange Commission. FDIC insured banks that

are not members of the Federal Reserve System ("insured nonmember banks") and securities trade groups, have raised the issue of whether a subsidiary of an insured nonmember bank may lawfully engage in securities activities that would be prohibited to the parent bank by section 21 of the Glass-Steagall Act. The Board of Directors has considered the issue, and is adopting this statement of policy to set forth its views in order to provide general guidance to interested persons.

In adopting this statement of policy, the FDIC recognizes its ongoing responsibility to ensure the safe and sound operation of insured nonmember banks, and recognizes, depending upon the facts, that certain risks may be inherent in involvement of subsidiaries of nonmember banks in securities activities. Accordingly, the views set forth herein are not intended to express any view as to the safety and soundness of any particular activity or affiliation.

As the Regulatory Flexibility Act of 1980 (Pub. L. 36-354) does not apply to general statements of policy, no regulatory flexibility analysis is required. Additionally, as the statement of policy does not establish any recordkeeping or reporting requirements, the Paperwork Reduction Act of 1980 (Pub. L. 96-511) is inapplicable. As statements of policy and interpretative rules are not subject to sections 4(b) through (d) of the Administrative Procedure Act, as amended, (5 U.S.C. 553(b)-(d)), this statement of policy may be issued in final form without opportunity for public comment and may be made immediately effective upon its publication in the *Federal Register*.

FDIC Statement of Policy on the Applicability of the Glass-Steagall Act to Securities Activities of Subsidiaries of Insured Nonmember Banks.[1]

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1. This statement of policy only applies to insured nonmember banks. Moreover, insured nonmember banks that are members of a bank holding company system will also need to take into consideration the restrictions of sections 4(a) and 4(c)(8)) of the Bank Holding Company Act (12 U.S.C. 1843(a), 1843(c)(8) and Federal Reserve Board regulations before entering into securities activities through subsidiaries.

This statement of policy addresses the applicability of the Glass-Steagall Act to securities activities of subsidiaries of insured nonmember banks. It is not intended to address any other issues that may be raised by such activities.

It's the opinion of the Board of Directors of the FDIC that the Banking Act of 1933, popularly known as the Glass-Steagall Act and codified in various sections of title 12 of the United States Code, does not, by its terms, prohibit an insured nonmember bank from establishing an affiliate relationship with, or organizing or acquiring, a subsidiary corporation that engages in the business of issuing, underwriting, selling or distribution at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities.[2] While the Glass-Steagall Act was intended to protect banks from certain of the risks inherent in particular securities activities it does not reach the securities activities of a *bona fide* subsidiary of an insured nonmember bank.

Section 21 of the Glass-Steagall Act (12 U.S.C. 378), the only provision of the Act that is applicable by its terms to insured nonmember banks, provides, in part, that it shall be unlawful for:

> Any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing * * * stocks, bonds, debentures, notes or other securities, to engage at the same time to any extent whatever in the business of receiving deposits * * *

This section does not address the actions of subsidiaries or affiliates.

The only provisions of Glass-Steagall that prohibit affiliations between banks and corporations engaged in securities activities apply solely to member banks of the Federal Reserve System. Section 20 (12 U.S.C. 377), for example, specifically provides

2. The FDIC of course recognizes its ongoing responsibility to ensure the safe and sound operation of insured nonmember banks, and, depending on the facts, the potential risks inherent in a bank subsidiary's involvement in certain securities activities.

that no *member* bank shall be affiliated with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution of stocks, bonds, debentures, notes or other securities. Section 32 (12 U.S.C. 78) prohibits persons who are officers, directors, or employees of corporations that are primarily engaged in certain securities activities, or partners or employees of partnerships so engaged, from serving as directors, officers, or employees of *member* banks.

In a 1981 decision involving section 4(c)(8) of the Bank Holding Company Act, sections 16 and 21 of the Glass-Steagall Act,[3] and Federal Reserve Board Regulation Y (12 CFR Part 225) permitting bank holding companies to advise closed-end investment companies, the Supreme Court affirmed that section 21 applies only to banks and *not* to their nonbank affiliates. *Board of Governors of the Federal Reserve System* v. *Investment Company Institute*, 450 U.S. 46 (1981). The Court indicated at footnote 24 that:

> We agree with the Court of Appeals that Sections 16 and 21 apply only to banks and not to bank holding companies. Section 21 prohibits firms engaged in the securities business from also receiving deposits. Bank holding companies do not receive deposits, and the language of section 21 cannot be read to include within its prohibition separate organizations related by ownership with a bank, which does receive deposits.

The Court went on in the same footnote to quote the following exchange between Senator Glass, co-sponsor of the bill that became the Glass-Steagall Act, and Senator Robinson:

> Mr. Glass: Here (section 21) we prohibit the large private banks whose chief business is investment business,

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3. Section 16 (12 U.S.C. 24 Seventh) provides that national banks may not, with certain exceptions, deal in securities except to buy and sell securities solely upon the order and for the account of customers. The exception for dealing in securities upon the order of customers is incorporated into the first paragraph of section 21 and thus applies to member and nonmember banks alike.

> from receiving deposits. We separate them from the deposit banking business.
> Mr. Robinson of Arkansas: That means if they wish to receive deposits they must have separate institutions for that purpose?
> Mr. Glass: Yes.

The Court also rejected the argument that a bank and its holding company should be treated as a single entity for the purposes of sections 16 and 21, stating that the structure of the Glass-Steagall Act itself indicates the contrary. *Id.* at n. 24.

Although the Supreme Court in *Board of Governors* v. *ICI* did not consider section 21 in the context of a bank and its subsidiary, we are of the opinion that the Court's conclusion regarding section 21 and holding company affiliates is equally applicable in this instance. Thus, the FDIC does not believe that it would be warranted in extending the reach of the prohibitions of section 21 of the Glass-Steagall Act to *bona fide* subsidiaries of insured nonmember banks. The FDIC intends, however, to continue to monitor closely developments related to the securities activities of bank subsidiaries.

By Order of the Board of Directors.

Dated: August 23, 1982.

Federal Deposit Insurance Corporation.

Hoyle L. Robinson.

Executive Secretary.

[FR Doc. 82-24450 Filed 9-2-82: 8:45 am]
Billing Code 6714-01-M

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20849

July 16, 1982

The Honorable William M. Isaac
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Chairman Isaac:

The School Street Mutual Fund has registered with the Commission as an investment company under the Investment Company Act of 1940. The Fund also has pending before the Commission a registration statement under the Securities Act of 1933 which, if effective, would permit the fund to sell its securities to the public. Pursuant to Section 8(a) of the Securities Act, the fund has applied to the Commission to declare this registration statement immediately effective. Under Section 8(a), the Commission may take such action only upon consideration of certain factors, including the public interest.

The School Street Fund involves a novel arrangement whereby wholly-owned subsidiaries of The Boston Five Cents Savings Bank, a state-chartered mutual savings bank under the FDIC's jurisdiction, will act as investment adviser to the fund and as distributor of fund shares. The legality under the Glass-Steagall Act and other banking laws of this proposed relationship between a banking institution and an investment company is unclear.

Of course, the Commission does not administer the Glass-Steagall Act or other federal banking laws. However, since Section 8(a) compels the Commission to consider the public interest as one element of its decision whether to accelerate the effectiveness of a Securities Act registration statement, the legality under the banking laws of the School Street Fund's proposed activities is an

issue of concern to the Commission. In addition, novel and innovative relationships between banks and investment companies are becoming more common. Accordingly, similar issues may come before the Commission in the future.

For these reasons, the Commission has determined to seek the advice of the FDIC before proceeding with the fund's acceleration request. Insofar as the Commission is aware, the FDIC has not taken a position on the banking law issues which this type of bank/investment company relationship presents. Therefore, the Commission has directed the staff to obtain the opinion of the FDIC as to whether operation of the fund in the proposed manner would be lawful under the Glass-Steagall Act and other laws with respect to which the FDIC has jurisdiction.

If you have any questions regarding this request, please direct them to Joel H. Goldberg, Director of the Division of Investment Management (202/272-2750).

By the Commission.

George A. Fitzsimmons
Secretary

/s/ Shirley E. Hollis

By: Shirley E. Hollis
Assistant Secretary